



Towards Responsible Government

The Report of the
National Commission of Audit

Phase One

February 2014

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Australian Government
National Commission of Audit

14 February 2014

The Hon Tony Abbott MP
Prime Minister
Parliament House
CANBERRA ACT 2600

The Hon Joe Hockey MP
The Treasurer
Parliament House
CANBERRA ACT 2600

Senator the Hon Mathias Cormann
Minister for Finance
Parliament House
CANBERRA ACT 2600

Dear Prime Minister, Treasurer and Minister

In accordance with the Terms of Reference we are pleased to present the First Report of the National Commission of Audit.

This Report – *Towards Responsible Government* – examines the Commonwealth’s finances. We provide advice and recommendations on what we believe should be done now to ensure that spending is placed on a sustainable long-term footing. Our recommendations will help to achieve savings sufficient to deliver a surplus of 1 per cent of GDP by 2023-24. We have not considered taxation in detail which is to be reviewed through another process.

The Commission received more than 300 submissions and met with many people within Commonwealth, State and Territory governments and from the broader community. As well as these submissions and the work undertaken by the Commission itself, our Report drew on material and analysis that was in the public domain. This material is referenced in the Appendix to our Report.

The Commission has focused on the fifteen largest and fastest growing programmes which have driven the unsustainable increases in expenditure commitments.

The Commission will comment further on public sector performance, efficiency and accountability in Phase Two of our Report. However, the Commission believes that there would be further significant savings from an independent in depth review on a portfolio-by-portfolio basis.

In undertaking its review of the size and scope of government, the Commission concludes that reforming the Federation is a matter of fundamental importance. We have made recommendations to this effect which will strengthen the Federation which has served us so well.

The Commission has been assisted by a highly professional Secretariat led by Mr Peter Crone. We record our appreciation for the efforts of the talented and motivated women and men drawn from your departments who helped us prepare this Report. We also record our appreciation for those who have made submissions and given us advice.

Yours faithfully

A.F (Tony) Shepherd AO
Chairman

Peter Boxall AO

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The Hon Amanda Vanstone

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The Commission also acknowledges the assistance provided by Stephen Matchett, Jai Mullens, Pandora Livanes and Tameena Jacob.

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Appendix

Volume 1

Volume 2

The Appendix provides further details on the analysis and research undertaken for the Phase One Report of the National Commission of Audit. It includes consideration of issues relevant to the Terms of Reference, as well as input from submissions received from government, industry, community organisations and individuals.

Executive Summary

The National Commission of Audit was established to examine the scope and efficiency of the Commonwealth Government, to review the state of its finances and to advise on steps to ensure Australia's long-term fiscal strategy is responsible and sustainable.

The Commission has found Australia confronts a substantial budgetary challenge – the fiscal situation is far weaker than it should be and the long-term outlook is ominous due to an unsustainable increase in expenditure commitments.

There is a big task ahead to restore the nation's finances. The Commission has therefore focused on the biggest and fastest growing areas of spending to identify savings. A detailed portfolio-by-portfolio review should yield significant additional savings.

As a nation we have a responsibility to complete the task of budget repair. If we succeed we will remove an unfair future burden on young people. We will also help to shock-proof the economy against future crises. More efficient government will create greater overall capacity and will allow us to generate more wealth.

The interests of the nation are best achieved by promoting responsible government.

Fiscal responsibility and reducing government expenditure does not have to harm the economy if it is done incrementally, fairly and as part of a well explained programme of reform.

'Business as usual' is not an option for Australia. The Commission therefore proposes 64 recommendations to place Commonwealth spending on a more sustainable long-term footing.

We have looked at a wide range of options across major programmes. The recommendations in this report are the ones which the Commission considers meet the Principles of Good Government.

Of course these are recommendations only and it is the decision of the elected Government which of them, if any, they choose to progress.

The Commission has not undertaken detailed costings of these recommendations but depending on when they are implemented we expect that significant savings will be built up over time.

By 2023-24 these savings could reach \$60 to \$70 billion per year and could be higher once additional savings from lower interest costs arising from reduced debt levels are taken into account.

In many areas, reducing government expenditure as well as red tape and compliance costs will open opportunities for the private sector. Also the private sector will often be better placed to deliver services more efficiently.

We also recognise that any consideration of the size, scope and efficiency of government must extend to the operation of our Federation. It is wasteful and costly for different levels of government to intervene in the same areas of spending.

Reform of the Commonwealth's fiscal strategy is a long-term project for our whole society that goes far beyond the normal budget period. It will require an integrated approach with hard-headed decisions on spending priorities, a preparedness to embark on meaningful tax reform, an ambitious approach to recasting Commonwealth-State relations and, above all, a concerted reform agenda to support productivity and growth.

The extent of what is required over the next 10 years and beyond needs to be appreciated by everybody. Governments, commentators and the media generally have a role to play in ensuring that they understand and shape the debate in an informative way for Australians.

Government should not make promises that cannot be afforded over the long-term. Households understand they must live within their means. Governments must do so too.

In undertaking this Audit, the Commission has been guided by the importance of fairness, recognising that fairness has a strong relationship to our sense of confidence and our ability to work together effectively.

Inevitably vested interests will seek exemption from the shared sacrifice and common purpose. We must reassess our expectations of government in the light of the overall good. National interest and not special interest must prevail.

It is only in this way that we can maintain a fair and cohesive society and afford the level of support to the deeply disadvantaged which is the hallmark of a civilised society and a defining characteristic of Australia.

Principles of Good Government

In examining the scope, efficiency and sustainability of the Commonwealth Government and its programmes, the Commission has developed a set of common sense principles to guide its deliberations.

These core principles have shaped our approach and helped ensure our fiscal goals can be achieved in a way the community understands and supports.

1. **Live within your means.** All government spending should be assessed on the basis of its long-term cost and effectiveness and the sustainability of the nation's long-term finances.
2. **Harness the benefits of the Federation but demand a responsible Federation.** The Commonwealth's activities should be guided by the Constitution. The States and Territories should be free to compete amongst themselves, respecting the regional differences of a big continent. However, there will be occasions where the national interest calls for a cooperative and national approach.
3. **Protect the truly disadvantaged.** Government should protect the truly disadvantaged and target public assistance to those most in need.
4. **Respect personal responsibility and choice.** Government should not and cannot eliminate or insure every risk to the community. Personal responsibility and choice are fundamental to our democratic system.
5. **Assure value for taxpayers' money and ministerial responsibility.** Governments spend taxpayers' money not the government's money. They must assure value across all expenditure and constantly strive to improve productivity and eliminate waste. All programmes should be regularly assessed for effectiveness against their stated goals and outcomes. Ministerial responsibility is imperative and departments should be the primary source of policy advice.
6. **Be transparent and honest.** Transparency and honesty are fundamental to accountability. Government policy goals and programme outcomes must be transparent. Transparency in government will better illuminate the choices we face and the decisions needed for the overall good of the nation. Spending on lower priorities, however popular at the time, needs to be resisted.
7. **Reduce complexity.** Government should reduce complexity which impacts on its own operations, the operations of the States and Territories and the activities of the community and business. Reporting requirements should be kept to a minimum.

8. **Avoid regulation as a first response to a problem.** Adding new regulations to deal with problems should be the last resort and introduced only when existing laws prove inadequate and the risks of no regulation outweigh the costs to the community.
9. **Act in the public interest and recognise the benefits of markets.** In competitive markets, customers, not producers, take precedence. Competition and contestability drive lower costs, improve quality and give people what they want. Government should act in the public interest and only intervene in markets where market solutions fail to produce the best outcome for the nation as a whole.
10. **Do not deliver services if others are better placed to do it.** The delivery of public services should, wherever practicable, be handed to those organisations and levels of government closest to those receiving the service and should not be duplicated.

The state of the Commonwealth's finances and fiscal outlook

The Government's fiscal strategy stipulates a budget surplus equivalent to 1 per cent of Gross Domestic Product prior to 2023-24 and this is key to our Terms of Reference. The Commission regards this as a prudent and sensible goal. With no further global or domestic shocks, it will allow us to pay down our debt to future-proof the economy against the next crisis.

For the year ended 30 June 2013, the Commonwealth Government recorded an underlying cash deficit of \$18.8 billion, or 1.2 per cent of GDP. In the current 2013-14 financial year the underlying cash balance is projected to record a deficit of \$47.0 billion or 3.0 per cent of GDP. This is the sixth consecutive budget deficit. We have spent beyond our means for too long.

The 2013-14 Commonwealth finances reflect:

- projected Commonwealth payments of \$409 billion, amounting to 25.9 per cent of GDP; and
- projected Commonwealth taxation receipts of \$343 billion or 21.8 per cent of GDP. After taking account of some \$21 billion of expected non-tax receipts, total Commonwealth revenue is projected to be 23.1 per cent of GDP.

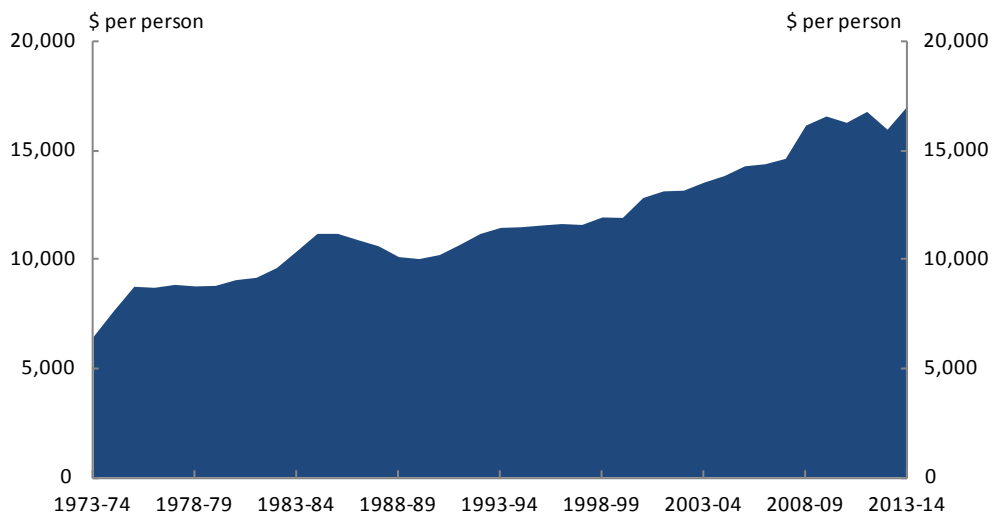
Commonwealth Government spending as a share of GDP remains close to the recent peak of 26.0 per cent recorded in 2009-10 and is well above the average of the past 20 years of 24.6 per cent of GDP.

The size and scope of government has increased significantly over time. Over the last 40 years government spending has nearly tripled in real terms, from around \$6,000 per

person per year to over \$15,000 per person today. (See Chart 1.) The growth in real payments per person reflects the greater role that government plays in the lives of Australians and the economy.

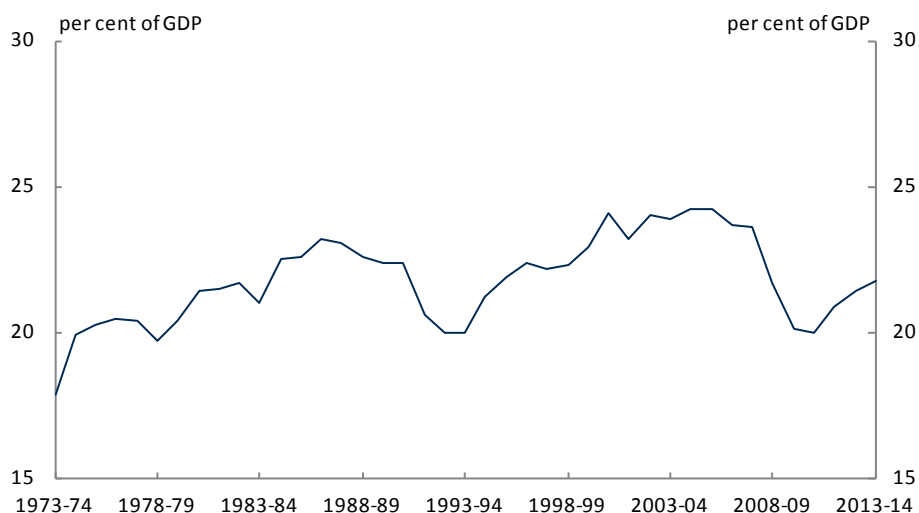
As well as government policy and higher expectations from the community, higher public spending reflects the ageing of Australia’s population and the fact that there are, proportionally, far more older people now (who tend to receive more government services). While we can’t do anything about our country’s age profile, we can curtail our spending.

Chart 1: Real spending per person



Commonwealth tax receipts as a share of GDP have been subdued in recent years. As shown in Chart 2, at a current level of 21.8 per cent of GDP tax collections are below the 20-year average of 22.4 per cent of GDP and well below the 23.6 per cent of GDP recorded in 2007-08 just prior to the global financial crisis.

Chart 2: Commonwealth taxes as a share of GDP



The Commission's approach

The main focus of the Commission was on the largest and fastest growing areas of Commonwealth spending, industry assistance and other programmes and the rationalisation of Commonwealth bodies and agencies. A more detailed review of every portfolio will no doubt find further ways of improving government.

Of the \$409 billion of total Commonwealth spending in 2013-14 only 12 per cent (or just under \$50 billion) is categorised as agency and departmental spending. The remaining 88 per cent of spending (or some \$360 billion) is classified as 'administered' payments. The vast majority of these payments are governed by legislation and established eligibility rules which mean there is little discretion as to whether they are made. They largely include demand-driven payments in social security and health.

It is important to reduce waste and improve efficiency in government. However, the savings required to restore the nation's finances will need to go well beyond simply reducing costs in the public service.

Structural savings in the largest and fastest growing programmes must be pursued over coming years if the Government's fiscal target, as specified in the Terms of Reference, is to be realised.

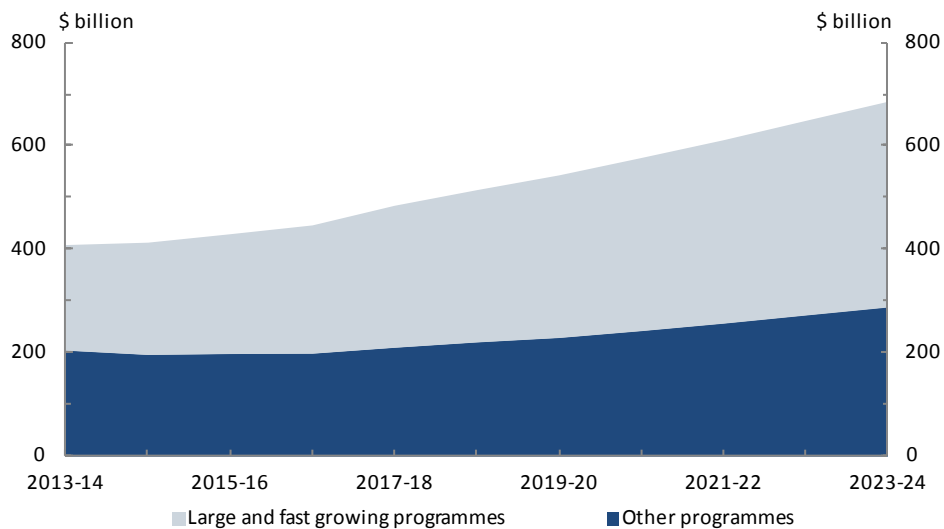
Looking ahead 10 years, any outlook for the Commonwealth's finances will necessarily be inexact. Nonetheless, on the spending side it is possible to obtain a reasonable approximation of likely trends on the basis of what we know about expected population growth, demographic changes, the formulas used to increase payments each year and likely take-up rates for certain programmes.

As shown in Chart 3, projected Commonwealth spending is likely to rise from \$409 billion today to some \$690 billion in nominal terms over the next 10 years.

Over this period combined growth in spending on social security, welfare, health and education is projected to contribute the most to growth in total expenses.

Most of the future growth in spending is concentrated in the 15 largest and fastest growing Commonwealth programmes, which account for around 70 per cent of total growth in spending over this period.

Chart 3: Projected Commonwealth spending



High level overview of major programmes

Of these 15 programmes, the **Age Pension** is by far the largest. Currently close to \$40 billion, the Age Pension is forecast to rise by 6.2 per cent per year from 2013-14 to 2023-24, when spending is projected to be over \$72 billion. Spending will continue to grow from there.

Of this \$32 billion increase, around 40 per cent is driven by current indexation arrangements with most of the remainder due to increasing numbers of recipients.

Three large health programmes — Medicare, hospitals and pharmaceutical benefits — now account for over \$40 billion in Commonwealth spending.

The **Medicare Benefits Schedule** currently costs around \$19 billion and is expected to grow by 7.1 per cent per year until 2023-24 and continue growing. The increase in expenditure largely reflects population growth and increasing use and cost of medical services.

Spending on **hospitals** (currently \$14 billion) is expected to rise to around \$38 billion by 2023-24 and continue growing. The Commonwealth contributes to the funding of public hospitals in the States through Australian Health Care Agreements. With annual growth of 10.4 per cent between 2013-14 and 2023-24, spending on hospitals is one of the fastest growing areas of government spending.

Spending on the **Pharmaceutical Benefits Scheme** is projected to grow by 5.4 per cent per year from 2013-14 to 2023-24 and continue growing. At present, nearly 80 per cent of the Scheme's expenditure is attributable to concessional recipients.

The **National Disability Insurance Scheme** commenced in 2013 and is expected to grow rapidly. From a starting point of less than \$0.5 billion for the next three years, average annual growth is projected to be over 45 per cent from 2013-14 to 2023-24. This means that by 2023-24, NDIS spending by the Commonwealth alone will be around \$11 billion.

Payments to **Carers** are projected to increase by 9.6 per cent per year between 2013-14 and 2023-24 and continue growing. Rapidly rising beneficiary numbers are one of the main drivers, with annual increases in excess of 10 per cent for recipients of some payments.

Aged care is growing strongly and is forecast to double from its current level of around \$13 billion to \$26 billion in 2023-24 and continuing to grow. The increasing number of older Australians accessing aged care services is the main driver of this growth in costs. Residential care is the largest component of aged care spending.

In 2013-14, nearly \$16 billion is expected to be spent on the 820,000 recipients of the **Disability Support Pension**. Over the next 10 years spending on this Pension is projected to increase by 4.7 per cent per year. Population ageing drives part of the growth but a significant portion is due to indexation. The Disability Support Pension is indexed in the same manner as the Age Pension.

Growth in **child care** fee assistance and **Paid Parental Leave** is expected to be around 11.5 per cent per year between 2013-14 and 2023-24. This reflects increased usage of formal care, for which the Commonwealth provides two major subsidies and the proposed changes to the Paid Parental Leave scheme.

Family Tax Benefit is growing less strongly than other areas, but is still a substantial programme. At around \$19 billion, it makes up close to 5 per cent of all Commonwealth government spending and is projected to be over \$22 billion in 2023-24.

Commonwealth spending on **job seekers** is currently over \$10 billion. Growth in expenditure in this area is not projected to be large as it is dependent on the unemployment rate, which, consistent with the medium-term projection methodology is assumed to remain at around 6 per cent.

Commonwealth spending on education is around \$20 billion, with around \$13 billion on schools and the remaining \$7 billion on higher education.

Schools funding is expected to grow by 9.2 per cent per year to 2023-24. This growth largely reflects indexation arrangements and per student funding goals under the Better Schools Plan.

Growth in **higher education** funding (5.8 per cent per year between 2013-14 and 2023-24) partly reflects the effect of uncapping the number of bachelor degree places in Australian universities in a demand-driven system with the Commonwealth effectively underwriting places through subsidised student loan arrangements.

In 2013-14 around \$25 billion will be spent on **Defence**. This figure is forecast to increase above \$40 billion by 2023-24 and will rise to \$52 billion by then if the Government increases Defence spending to its target of 2 per cent of GDP. At the same time, Defence spending is

facing ongoing cost pressures, reflecting the increasing costs and complexity of military equipment (often associated with increased capability), and personnel.

Australia's **foreign aid programme** is forecast to grow on average by 9.6 per cent per year between 2013-14 and 2023-24. The vast majority of this growth is attributable to the previous government's commitment to Australia's foreign aid programme reaching 0.5 per cent of Gross National Income.

Revenue outlook

The Commonwealth is highly reliant on personal and corporate income taxes, which are closely linked to the economy's performance and the terms of trade.

The combination of the Commonwealth's high reliance on volatile taxes, combined with volatility in our terms of trade, imposes significant risks to the medium-term revenue outlook and increases uncertainty around revenue forecasts.

The long-term sustainability and stability of the Commonwealth's revenue is a serious matter.

The Commission has not, however, dealt extensively with taxation issues. This recognises that other processes will soon commence. The Government has committed to consult the community to produce a comprehensive Taxation White Paper with all aspects of the tax system 'on the table'. This White Paper, alongside the Government's proposed Federation White Paper, provides a significant opportunity to improve government and strengthen the economy.

The Commission has assumed tax receipts will rise in line with a strengthening economy, with the tax to GDP ratio recovering to normal levels over time. Once tax receipts reach 24 per cent of GDP — which is around the average level of tax receipts over the period from 2000 to the lead up to the global financial crisis — they are assumed to remain at that level.

This reflects a critical assumption that additional tax collections arising from bracket creep (as wages growth pushes taxpayers towards higher tax brackets) are partially returned by the government in the form of periodic income tax cuts. This is the established practice of Commonwealth governments over many decades.

If adjustments are not made for bracket creep the Commission estimates that a person earning the average wage and currently facing a marginal tax rate of 32.5 per cent will be taxed at a 37 per cent marginal tax rate by 2023-24. The marginal tax rate for a person on the minimum wage would rise from 19 per cent now to 32.5 per cent well before 2023-24. In the Commission's view, having proportionally more people subject to higher tax rates will have negative implications for Australia's economic growth.

The Commission's fiscal scenarios

The Commission has prepared two fiscal scenarios: a 'Business as Usual' scenario and a 'Reform' scenario.

These scenarios involve assessments and judgements about future growth in receipts and payments at the Commonwealth level and are based on assumptions around economic growth and inflation that are reasonable and sensible. Over the medium term, nominal GDP is projected to grow by just over 5 per cent per year, with inflation growing by around 2.5 per cent per year.

Under 'Business as Usual' it is assumed that Commonwealth spending out to 2023-24 follows a similar path to the one outlined in the Mid-Year Economic and Fiscal Outlook. Spending as a share of GDP is projected to reach 26.5 per cent of GDP at that time.

Tax receipts in the 'Business as Usual' scenario are assumed to remain at or below 24 per cent of GDP. When non-taxation receipts, such as dividends and other income, are included total Commonwealth receipts reach 25 per cent of GDP and remain at around that level.

In this 'Business as Usual' scenario the Commonwealth's Budget remains in deficit out to 2023-24 and beyond.

If this occurred, Australia would record an unprecedented run of 16 consecutive years of deficits (and more in prospect), with net debt rising to around 17 per cent of GDP or some \$440 billion. This would place a significant burden on future generations to bring the Budget back under control and of course reduces any buffer to meet future shocks.

If a shock hits and we don't have a buffer in place then it is more likely that governments will have to cut back dramatically and more painfully.

This is important if governments are to be conscious of not making cuts that impact on the most vulnerable.

In the Commission's 'Reform' scenario, a more moderate pace of spending growth occurs over the medium term. In particular, it assumes additional expenditure restraint starts in 2014-15 and is maintained through to 2023-24.

Under this scenario Commonwealth payments would decline from their current level of around 26 per cent of GDP to around 24 per cent of GDP by 2023-24.

Tax receipts in the 'Reform' scenario are assumed to be the same as the other scenario - remaining at or below 24 per cent of GDP. When coupled with non-taxation receipts total Commonwealth receipts are assumed to reach 25 per cent of GDP and remain at around that level.

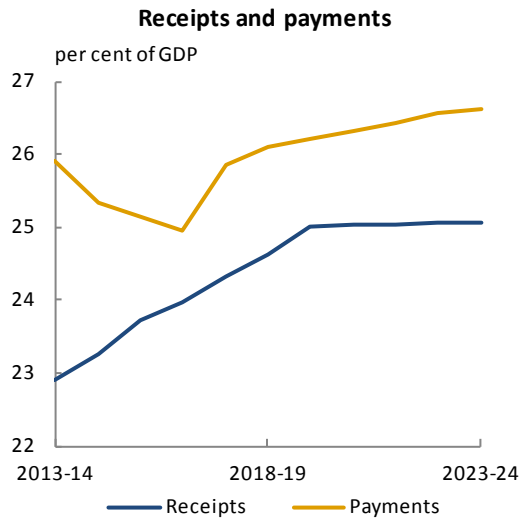
Under the 'Reform' scenario the Budget returns to surplus in 2019-20 with the surplus growing to 1 per cent of GDP by 2023-24.

Commonwealth net debt peaks at 15.1 per cent in 2016-17 under this scenario and then declines to just over 5 per cent of GDP.

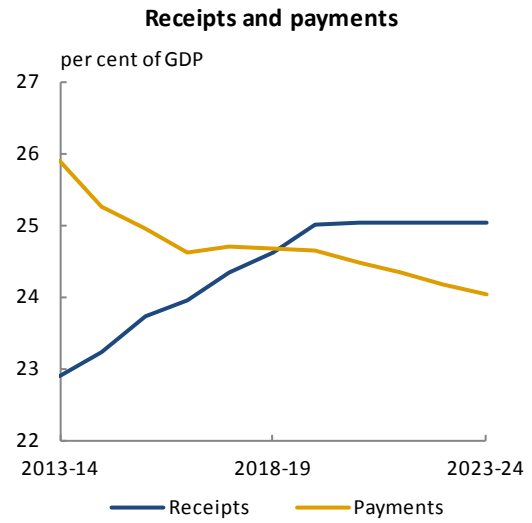
These scenarios are illustrated in Chart 4.

Chart 4: The Commission's fiscal scenarios

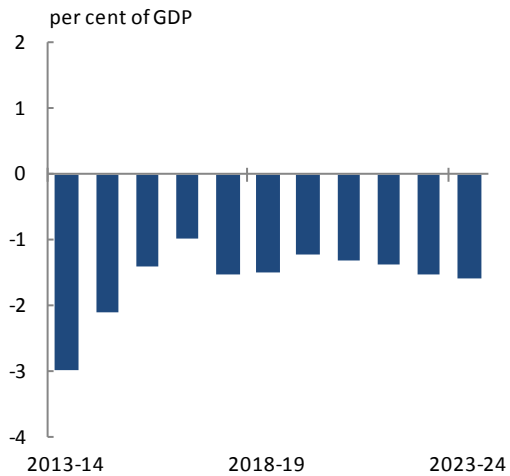
'Business as Usual' scenario



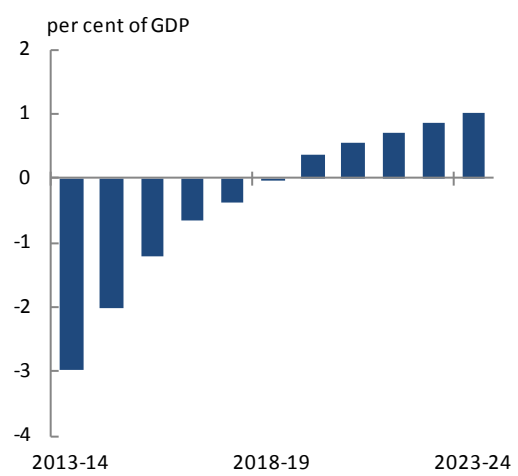
'Reform' scenario



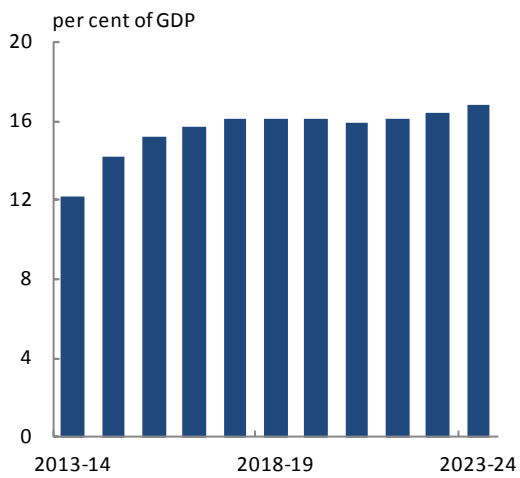
Underlying cash balance



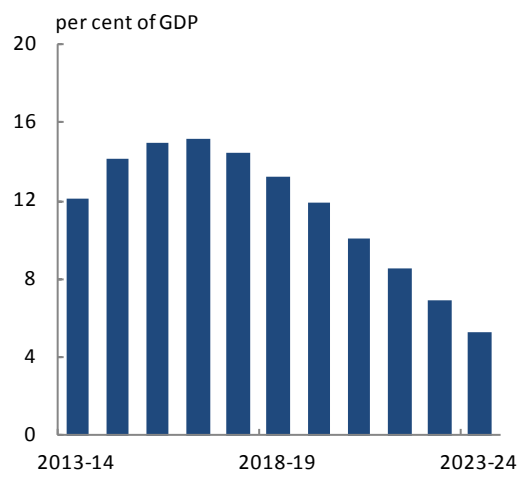
Underlying cash balance



Net debt



Net debt



Restoring the nation's finances

The Commission has identified those areas which must be addressed to place the Nation's finances on a sustainable footing.

The Commonwealth requires a credible medium-term fiscal strategy, which provides certainty. It requires acceptance of fiscal rules that set boundaries around government while continuing to allow some flexibility in implementing policy priorities. Adherence to these rules will help to shock-proof the economy.

Our federal system is not working as it should and reform of its operation is essential to the future of the nation. We must clearly delineate respective roles and responsibilities and reform the Commonwealth's financial relations with the States and Territories (hereafter 'the States'). The Commonwealth must withdraw from certain areas and in return, the States will need access to and control of a bigger and more sustainable revenue base. Reforming the Federation is essential to the improved accountabilities needed for responsible government in Australia.

Major reforms to the largest and fastest growing areas of Commonwealth spending offer the clearest opportunities for managing and restraining growth in overall government expenditure. Accordingly, the Commission has identified reforms to the 15 largest and fastest growing spending programmes to ensure they can be placed on a more sustainable footing. Their combined impact over time is the driver of the Commonwealth's fiscal challenge.

In addition the Government will need to rationalise and streamline many of the things it currently does and in some areas cease activity. This includes rationalising the number of bodies and agencies, ending many grant and other ineffective programmes, limiting industry assistance, streamlining functions and where possible devolving responsibility to the States.

The Government should apply more market-based and technological solutions to improve the quality and efficiency of its services. It should consider further opportunities for privatisation and outsourcing. It needs to make greater use of data and data analysis techniques and information technology. It should also make greater use of private sector expertise in the design and delivery of services including e-Government services.

Fiscal strategy and new fiscal rules

For the past 25 years there has been bipartisan support in Australia for fiscal policy guided by established rules and set with an eye to the medium term. This strategy was based on generating budget surpluses on average over the course of the economic cycle and reducing government debt.

However, in recent years, the strategy was discarded.

More than four years into the economic recovery from the global financial crisis the Budget should not be in deficit to the tune of 3 per cent of GDP as is currently in prospect for this year.

The Commission considers the central elements of the fiscal strategy that has been in place for nearly two decades should be restored to promote stability and consistency in Australia's overall fiscal framework.

However, execution of the fiscal strategy requires a more prescriptive approach, with a new set of operational rules to better frame fiscal policy choices and enable a more transparent assessment of government fiscal performance.

The Commission considers the surplus target of 1 per cent of GDP, included in its Terms of Reference, is appropriate and achievable. It should be part of the new fiscal rules. A target surplus of this size has been achieved historically and will ensure that meaningful inroads are made into reducing debt.

The Commission considers fiscal policy should be set with a view to reducing net debt over time.

In effect, this strategy of keeping net debt relatively low (or slightly negative) is designed to provide a 'corridor of stability' or safe harbour within which governments can operate. It will help to shock-proof the economy.

We also need discipline on the ratio of tax to GDP limiting the burden of taxation on the economy.

A pragmatic approach is to adopt a tax to GDP cap of 24 per cent, which is around the average level of tax receipts recorded over the period from 2000 to the onset of the global financial crisis. This would allow for some growth to occur in the tax to GDP share from the current tax level of 21.8 per cent of GDP as the economy strengthens.

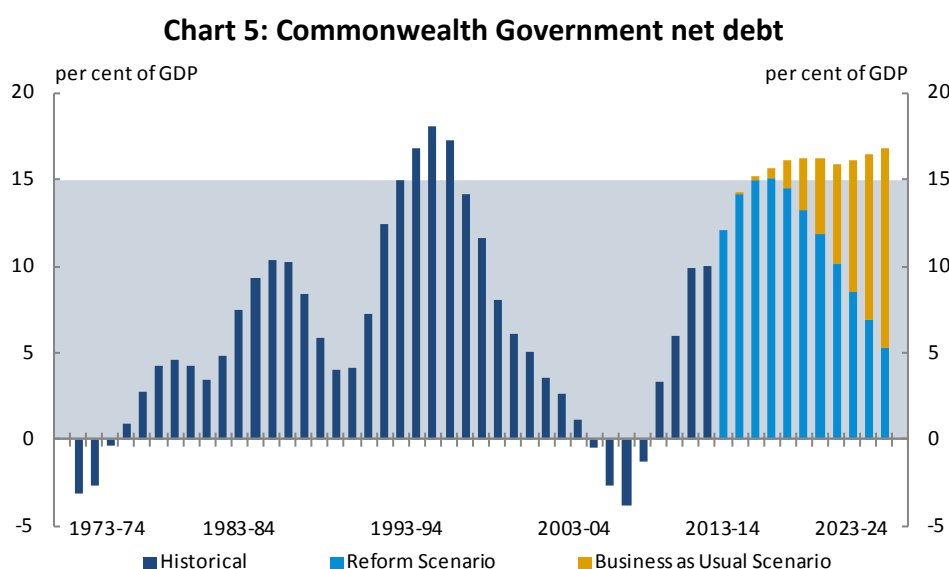
Overall, the Commission considers the Government should adopt a high-level fiscal strategy which seeks to achieve underlying cash surpluses, on average, over the cycle, improve the government balance sheet over time and limit the size of government.

Accordingly the Commission recommends the following fiscal rules:

- achieving a surplus of 1 per cent of GDP by 2023-24;
- substantially reducing net debt over the next decade; and
- ensuring taxation receipts remain below 24 per cent of GDP.

As shown in Chart 5 below, these rules would not be met under the ‘Business as Usual’ scenario. Australia’s net debt would rise above 15 per cent of GDP and remain elevated through to 2023-24 and beyond.

In contrast, under the ‘Reform’ scenario (which produces a surplus of 1 per cent of GDP by 2023-24) net debt would decline to around 5 per cent of GDP. Maintenance of small surpluses beyond this time would see net debt reduce further.



The Commission acknowledges fiscal rules should not be completely inflexible. In the event of a rare economic shock (for example of the order of the global financial crisis), the automatic stabilisers in the Budget should be allowed to operate, with discretionary fiscal policy used to support macroeconomic demand as appropriate.

In these circumstances, the core elements of the proposed rules would remain, possibly with an ‘escape clause’ which allows temporary adjustments to the timing and/or size of the surplus target, so as not to damage short-run growth.

Conversely, a temporary boost to tax receipts — arising from, for example, an unexpected and marked rise in the terms of trade — that pushed taxes over 24 per cent of GDP could be accepted as long as it was temporary and the proceeds were not spent but used to reduce the deficit or pay down debt.

The prudent design of escape clauses can provide flexibility to rules in dealing with rare events and are advocated by the International Monetary Fund as an acceptable part of a suite of fiscal rules. They do, however, need to be carefully specified.

Currently, there is no public mechanism for reporting a government’s progress against, and adherence to, the fiscal strategy. Having such a mechanism would improve accountability and transparency of a government’s fiscal situation and direction.

Within Australia, the Parliamentary Budget Office was established to inform the Parliament by providing independent and non-partisan analysis of the Budget cycle, fiscal policy and the financial implications of proposals.

The Commission recommends the *Charter of Budget Honesty Act 1998* be amended to require the Parliamentary Budget Office to report progress against the government's medium-term fiscal strategy following the release of the Final Budget Outcome each year.

The Commission also considers there is scope for improving the overall transparency of budget reporting.

There is currently no requirement for budget updates to include aggregate budget estimates any further than three years beyond the Budget year. However, at an aggregate level medium-term projections have been published in Budget updates for the past few years.

The Charter of Budget Honesty should be changed to make it mandatory for each fiscal update to include projections for the 10 years beyond the Budget year, including for spending and revenue aggregates and the underlying cash balance, based on current policy settings. Such an approach in the past may have avoided the situation we now find ourselves in.

The Commission considers the preparation and publication of a regular Intergenerational Report has been a positive development for Australia, particularly in raising awareness of the budgetary challenges of the ageing population.

The Intergenerational Report should be retained as a key document to increase budget transparency. There should be a requirement that it be produced within a specified period after the release of the National Census. In addition, the Commission considers future Intergenerational Reports should also cover the long-term sustainability of State and Territory budgets.

The Commonwealth's balance sheet

A government's balance sheet is an important measure of its financial position. Not only is it an indicator of short term fiscal sustainability and the government's ability to respond to economic shocks, it also reflects the debt and other liabilities that must be repaid by future generations.

The Commission considers there is merit in raising community awareness of the balance sheet's importance. A greater focus on the balance sheet would broaden the debate on fiscal policy and encourage better asset management.

Unfunded superannuation liabilities on the Commonwealth's balance sheet represent a significant risk to the long-term financial position of the Commonwealth. The unfunded

liability for defined benefit schemes is currently estimated at some \$150 billion rising to over \$350 billion by 2050. These liabilities will have to be paid for by future generations.

Steps should be taken now to better manage them. The main unfunded defined benefits scheme that continues to be open to new members is the Military Superannuation and Benefits Scheme. Australia has an obligation to look after our serving personnel particularly their cover for death and disability.

The Commission recommends that the Military Superannuation and Benefits Scheme be closed to new members and replaced by an accumulation scheme for new Australian Defence Force personnel. The new scheme should be designed in a way that recognises the special contribution these Australians make to the defence of the nation, including by ensuring that younger, lower rank and often shorter serving members have superannuation arrangements that are equitable when compared to those of long-serving, higher-ranking members.

In considering issues around the balance sheet, it is important to recognise governments take risks onto their balance sheet when they provide guarantees and loans (including concessional loans) to people, organisations and other countries. Examples include guarantees of \$13 billion of aged care accommodation bonds and \$3.3 billion in liabilities of the Export Finance and Insurance Corporation.

Public information on the attendant risks accompanying these guarantees and loans is relatively poor. By failing to properly price the risk taken on by government, there is insufficient tension to ensure the government balance sheet is used sparingly and carefully. The Commission recommends that the expected costs and risks of all existing and new Commonwealth loans and guarantees should be included in the Budget, meeting the same high standards expected of the corporate sector.

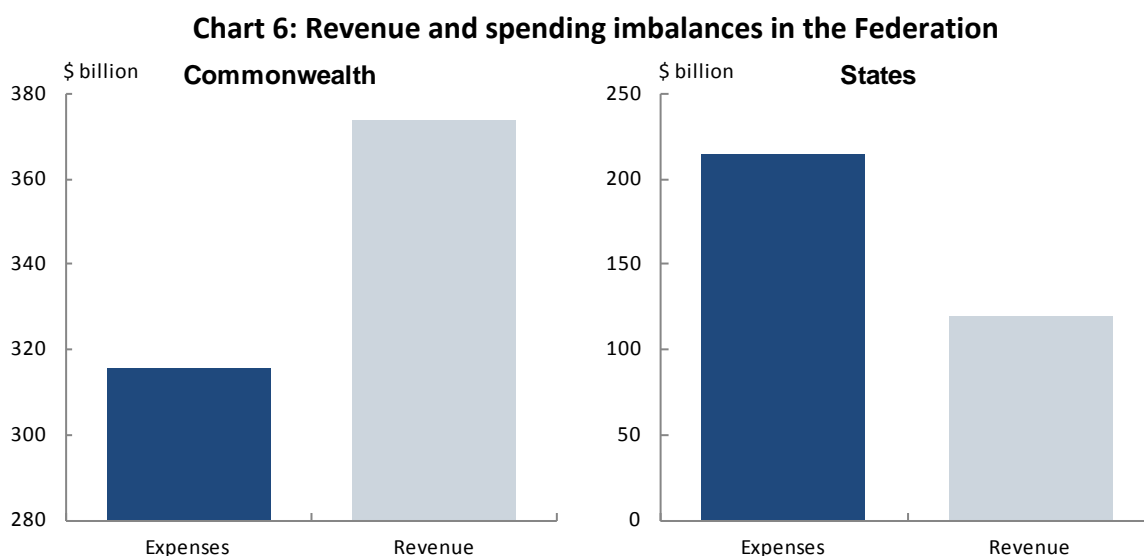
Reforming the Federation

The current operation of the Federation poses a fundamental challenge to the delivery of good, responsible government in Australia.

There are numerous spending examples with significant Commonwealth and State overlap, and numerous instances where the Commonwealth provides tied funding to the States to deliver specific outcomes or policies.

A feature of the Australian Federation is the extent of the imbalance in the revenue raising capacities and spending responsibilities of the different tiers of government (the vertical fiscal imbalance).

A shown in Chart 6, this reflects the fact that the Commonwealth raises revenues in excess of its spending responsibilities, while State governments have insufficient revenue from their own sources to finance spending responsibilities.



The Commission recommends that the degree of vertical fiscal imbalance within the Federation be substantially reduced with a corresponding reduction in the Commonwealth’s taxation revenue.

This would have a beneficial impact on the efficiency and effectiveness of governments. It would also increase the accountability of Commonwealth and State governments as the link between their taxing and spending decisions would be clearer to the electorate.

Any reform of financial arrangements cannot be done in isolation from the need to rationalise the duplication of expenditure responsibilities between different levels of government.

In determining ‘who should do what’ the Commission considers two key principles should apply – subsidiarity and sovereignty.

Under the principle of subsidiarity, policy and service delivery should, as far as practicable, be devolved to the level of government closest to the people receiving the services. This recognises sub-national governments are likely to have greater knowledge of the needs of citizens affected by their policies. It allows programmes to be tailored to meet community needs and recognises the significant differences across the nation.

Under the principle of sovereignty, as far as practicable, each level of government should be sovereign in its own sphere. When reviewing roles and responsibilities, government activities should be allocated to one level of government where possible. This provides greater clarity and accountability.

In addressing the issue of vertical fiscal imbalance, the Commission supports an arrangement whereby the Commonwealth would lower its personal income tax rates to allow room for the States to levy their own income tax surcharge.

The impact of lower revenue collections for the Commonwealth would be offset through an equivalent reduction in the payment of other financial assistance to the States. In other words, the States would receive a new untied source of revenue (through the personal income tax system) in place of tied grants.

The Commission has also examined issues around horizontal fiscal equalisation within the Federation and recommends moving toward a model where there is minimal redistribution between the current donor States (New South Wales, Victoria, and Western Australia) as well as Queensland, but with targeted distribution towards the current recipient States (South Australia, Tasmania, the Australian Capital Territory and the Northern Territory).

Under this approach all States would receive an equal per capita distribution of goods and services tax collected. However, to preserve the current share of the fiscally-weaker States, the Commonwealth would make 'top up' payments out of its own revenue base (to effectively increase the size of the pool).

As part of any agreement to move to new financial arrangements within the Federation, it would be necessary to negotiate a transfer of responsibilities for areas of spending where the Commonwealth currently makes tied grants.

Reform of the Federation including by addressing the problem of vertical fiscal imbalance provides an opportunity to significantly reduce duplication and red tape. It would also allow the Commonwealth to significantly reduce its involvement in several key areas such as education and aspects of the health system thereby improving efficiency and facilitating greater accountability.

Any changes to Commonwealth-State financial architecture along the lines outlined above would represent a substantial reform. The detailed design and ultimate implementation of any changes would be complex and take some time to implement. That is no reason for this reform not to be undertaken.

In the meantime, immediate steps are needed to simplify the large number of existing Commonwealth-State agreements.

In recent decades, the operation of the Federation has been characterised by a proliferation of small payments to the States, with increasing Commonwealth control involving excess red tape and excessive reporting requirements.

As at 1 July 2013 there were 144 agreements in place under the Intergovernmental Agreement on Federal Financial Arrangements.

All National Partnership Agreements should be reviewed, with a view to rationalising their number. This would reduce the administrative burden for both the Commonwealth and State governments.

At the same time, it would be useful to re-examine performance reporting requirements, along with broader data and transparency requirements.

If a substantial rationalisation of National Agreements and National Partnership Agreements could be achieved alongside a streamlining of reporting and data requirements, then the role of the COAG Reform Council would be substantially diminished. It could be abolished as a separate entity, with its reporting role assumed by the Productivity Commission.

Managing expenditure growth

Major reforms to the 15 largest and fastest growing areas of Commonwealth spending are essential for managing and restraining growth in overall government expenditure. There are also worthwhile opportunities to improve the effectiveness of government by more tightly targeting industry assistance, re-assessing other significant Commonwealth programmes and reforming programmes that duplicate State responsibilities. A detailed portfolio-by-portfolio review would no doubt yield further worthwhile savings.

Throughout its deliberations the Commission has been guided by the overall Principles of Good Government articulated earlier – going to the question of what governments should do and what individuals should do for themselves. It is also important to ensure that the government lives within its means and spends taxpayer funds well, including through the appropriate targeting of payments.

The Commission has made recommendations on 15 major programmes to improve their effectiveness and better manage overall expenditure growth.

- The **Age Pension** should be maintained as an essential part of Australia's social safety net, but changes are necessary to keep it affordable and appropriately targeted. This includes changing benchmarking arrangements and eligibility requirements. As many Australians make significant decisions in the lead up to their retirement, ample warning should be provided to future retirees of any significant changes. No existing recipient of the Age Pension will have their pension amount reduced in real terms as a consequence of the Commission's recommendations. Under the Commission's proposal to benchmark the Age Pension to 28 per cent of Average Weekly Earnings over a period of around 15 years, the Pension will still increase but will grow more slowly than in the recent past. From 2027-28, for new recipients, the Commission proposes changes to Age Pension eligibility including a

comprehensive means test (including for some recipients part of the value of the principal residence) as well as tighter targeting arrangements. Further increases in the Age Pension eligibility age are also recommended from 2033 to establish a formal link to life expectancy.

- The Commission supports the **National Disability Insurance Scheme** but considers it should be implemented in a way that is fiscally sustainable and able to meet the expectations of people with disabilities. The Commission believes there should be a slower roll out of the scheme. It is also essential that the cost of the scheme be strictly controlled. The governance arrangements for the NDIS are complex, with multiple layers of responsibility, and should be reformed. This can be achieved by making the National Disability Insurance Agency a prescribed statutory agency with a Chief Executive Officer reporting directly to the Commonwealth minister. The governance changes would have no impact on eligibility for the NDIS or the proposed financial contributions of the Commonwealth and the States.
- **Health care** spending represents the Commonwealth's single largest long-term fiscal challenge, with expenditure on all major health programmes expected to grow strongly to 2023-24 and beyond. Putting health care on a sustainable footing will require fundamental changes to all the components of the health system. Those with the capacity to pay should take greater responsibility for their own health care needs. Co-payments for all **Medicare** funded services are proposed along with reforms to improve the effectiveness of private health insurance arrangements and the effectiveness of Medicare. The Minister for Health should also be tasked with developing longer term options for reforming Australia's health care system.
- Strong growth in **hospital funding** is largely driven by the Commonwealth's commitment to fund 45 per cent of the efficient growth in public hospital costs from 2014-15 and 50 per cent from 2017-18 onwards. The Commission considers that public hospital service provision should remain the responsibility of the States and that hospital funding should be considered in the context of addressing vertical fiscal imbalance. A closer matching of revenue-raising capacity with expenditure responsibilities would result in greater flexibility to the States to deliver their public hospital services. The Commonwealth could renegotiate the health funding commitments and, in the meantime, limit its funding contribution to public hospital services to 45 per cent of the efficient growth in this cost.
- The **Pharmaceutical Benefits Scheme** is an integral part of the health system but a more holistic approach is needed to manage it. The Commission proposes that a new independent authority oversee management of listing drugs within a designated seven year funding envelope. Co-payment arrangements for the PBS should also be changed so that all users pay at least some contribution to the cost of medicines. To improve consumer choice, the pharmacy sector should be opened to competition.

- Around 70 per cent of Australian families currently receive some form of support through **Family Tax Benefits** A and B. Family Tax Benefits should be better targeted to those in need and simplified with a view to boosting workforce participation. The Commission recommends Family Tax Benefit Part B be abolished with a new supplement paid to sole parent families who lose this benefit. Eligibility for Family Tax Benefit Part A should also be tightened.
- The Commission recognises **Paid Parental Leave** has the potential to support maternal and child health. However, the benefits of Paid Parental Leave have to be balanced with the cost to the Commonwealth Budget and the principle of targeting expenditure to those most in need. The Paid Parental Leave payment should be capped at Average Weekly Earnings. The Commission considers that the company tax surcharge intended to partly fund the Scheme be retained, with savings from the lower cap redirected to an extended form of child care assistance. This would include assistance for in-home care and other types of care that are currently not subsidised. **Child care assistance** more generally should be simplified and broadened by replacing the current dual assistance system with a single, means-tested payment reimbursing all parents for a proportion of their child care costs.
- The Commission considers that there should be a fundamental clarification and simplification of the roles and responsibilities around **school education**. All policy and funding responsibility for government and non-government schools should be transferred to the States, with the Commonwealth providing annual funding in three separate, non-transferrable pools – one each for government schools, Catholic systemic schools and independent schools. Annual per student funding from 2018 would be set at 2017 levels in each State and indexed by a weighted average of the Consumer Price Index and the relevant Wage Price Index. Of course, national standards and performance reporting to the community should be maintained.
- The Commonwealth’s approach to **Defence** funding should be set on the basis of first determining the defence capability the country requires given the strategic circumstances it faces, and then matching this with appropriate funding. As part of the new Defence white paper process, the Government should assess the balance of strategic and fiscal priorities and how this compares with the commitment for Defence spending to reach 2 per cent of GDP within a decade. Defence budgeting should also be clarified and made more transparent, with greater scrutiny through the Government’s Expenditure Review Committee. The Commission also recommends that the Defence Materiel Organisation be reintegrated into the Department of Defence. New arrangements should be put in place to ensure greater individual accountability for the Secretary of the Department of Defence and the Chief of the Defence Force through a clearer delineation of their roles and responsibilities. The headquarters structure in Defence, including the number of

senior positions, should be realigned to 1998 levels. ASC Pty Ltd and Defence Housing Australia should be privatised.

- With an ageing population, further improvements could be made to the sustainability of Australia's **aged care** funding by progressing reforms previously suggested by the Productivity Commission. This includes reforms to ensure the full value of the principal residence is included in the current aged care means test. The Government should examine options to improve older Australians' access to equity in their principal residence, to help pay for part of the cost of their aged care services.
- The number of recipients of **Carer Payment** and **Carer Allowance** has grown very strongly over the last decade and assistance is not always well targeted. Assistance should be better targeted to those most in need. Changes should be made to: ensure Carer Payment is paid to those whose caring responsibilities limit their capacity to work; introduce an income test for the Carer Allowance; and impose a limit of one annual Carer Supplement payment per carer.
- The Commission recommends retaining Australia's current **unemployment benefit** arrangements as a major pillar of the social safety net but making changes to improve incentives to work including: requiring single young people without dependants or special exemptions on the Newstart Allowance to relocate to higher employment areas after 12 months on benefits; and increasing the income test withdrawal rate for the Newstart Allowance. The Commission also considers that containing future growth in the **minimum wage** would improve job opportunities, especially for lower skilled Australians. It will also ensure that government programmes to get people into work are more effective. The Commission also recommends that minimum wages be set on a State basis to better reflect local labour market conditions and cost of living expenses.
- The Commission recommends the **Disability Support Pension** be maintained as an essential part of Australia's social safety net but changes be made to ensure it remains fair and paid to those genuinely unable to work. This includes moving to gradually apply the new disability assessment and participation criteria, introduced in January 2012, to targeted groups of Disability Support Pension recipients previously grandfathered, including those under the age of 35 and those with some work capacity.
- The Commission considers that a rebalancing of the public and private contributions to **higher education** is warranted, reflecting the substantial private benefits that arise from higher education. The proportion of higher education costs paid by the Commonwealth should be decreased to an average of 45 per cent, with the proportion of costs paid by students rising to an average of 55 per cent. Changes

should be made to the existing Higher Education Loan Programme arrangements to increase repayment rates by lowering the income threshold at which student loans are repaid and ensure interest rates reflect the Commonwealth's full costs in making these loans including the cost of bad and doubtful debts. The Commission supports the current review of the demand-driven system and has concerns about the impact of that system on standards.

- The Commission considers that Australia's **foreign aid programme** needs to be more effectively managed and strategically targeted. Official development assistance should not be tied to a target such as 0.5 per cent of Gross National Income. The fragmentation of Australia's aid programme should be addressed with a new focus on outcomes achieved rather than the quantity of resources applied.

Other programmes and spending

The Commission has been asked to ensure taxpayers are receiving value for money by presenting options to eliminate wasteful spending and improve the overall efficiency and effectiveness with which government services are delivered.

In considering these opportunities within other Commonwealth programmes and spending, the Commission's 10 Principles of Good Government outlined above have been framed as follows:

1. Does the programme or activity serve a public interest and how has it performed against its target outcome?
2. Is there a legitimate and necessary role for government in this programme or activity?
3. Is the current role of the Commonwealth appropriate or is the programme a candidate for realignment within the Federation?
4. Can the programme or activities within it be transferred in whole or in part to the private sector or the not-for-profit sector?
5. If the programme or activity continues, could its efficiency be improved?
6. Is the programme an affordable priority within the fiscal environment?

The Commission has identified areas of Commonwealth expenditure where there is limited justification for its continued involvement or for maintaining involvement in the present form. In other cases, programmes could be better designed and targeted. For example:

- The shortcomings associated with governments providing **industry assistance** and 'picking winners' are well known. The Commission considers that funds devoted to

assisting uncompetitive industries could be better spent elsewhere or not spent at all. The Commission considers 22 programmes should be rationalised, phased-out or abolished.

- The Commission considers that **assistance to exporters** through the Export Finance and Insurance Corporation (EFIC), the Australian Trade Commission (Austrade) and the Export Market Development Grants scheme should be substantially reduced. Virtually all of Australia's exports by volume and value take place without EFIC's assistance and the support it provides mostly goes to a small number of large businesses. Similarly, much of Austrade's activities come at a high cost relative to the business opportunities generated. The Export Market Development Grants scheme should also be abolished as the benefits of exporting are largely captured by the business itself, with few broader benefits to the community. Forty per cent of recipients of these grants are businesses employing less than four people.
- The Commonwealth provides around \$9 billion per year supporting Australian **research and innovation**. The Commission supports this investment but considers the Government could take a more strategic, whole-of-government approach to the funding of research and development, including by reducing duplication in grant processes, better aligning research programmes to the Government's policy priorities, and ceasing a range of industry-specific programmes.
- The Commission considers there is scope to improve the effectiveness of **Indigenous** expenditure by significantly consolidating the 150 or so Commonwealth programmes, eliminating duplication with the States and discontinuing those programmes with no discernible effective outcomes. The savings from rationalisation could be redirected to a new voucher programme for accredited early childhood learning, schools, vocational training and universities for Indigenous children and youth.
- The **Australian Broadcasting Corporation** and the **Special Broadcasting Service Corporation** are both substantially funded by the Commonwealth. The Commission considers the ABC and SBS should be independently benchmarked against both each other and the commercial broadcasters to see whether efficiencies and savings can be achieved without compromising their capacity to deliver services, including to remote and regional Australia. Future funding decisions for these organisations should be informed by the outcome of this benchmarking exercise.
- **Housing affordability** and **homelessness prevention** are important priorities for Australia, however they are the responsibility of the States. As such, the Commonwealth should limit its involvement to providing rent assistance for income support recipients. The Commission proposes that arrangements for rent assistance be extended to include payments to public housing tenants (on the basis that

tenants commence paying market rates of rent). Increased funding for rent assistance would be paid for by redirecting funds currently provided to the States under existing housing agreements.

- Similarly, **vocational education and training** has traditionally been a State responsibility. At the moment, the Commonwealth provides separate funding to encourage businesses to take on apprentices and for development including through the National Workforce Development Fund. The Commission considers the Commonwealth should pass full responsibility for vocational education and training to the States with some requirements for national reporting and quality assurance. Recent reforms to achieve demand driven training should continue to be pursued by the States, along with improvements in mutual recognition of occupational licensing between States.
- Commonwealth involvement in **natural disasters** is identified as another area in which the States have primary responsibility. The Natural Disaster Relief and Recovery Arrangements should be replaced with a grant to affected States in the case of each major natural disaster with the Commonwealth contribution based on a designated proportion of the estimated reconstruction costs.
- The Commission recommends significant improvements to Commonwealth **grants programmes** by: establishing a central register within the Department of Finance with complete transparency on all grants awarded; establishing and publishing clear outcomes against which each grant is regularly assessed; reducing red tape by applying contemporary risk-based approaches to grant management; and decreasing the number of existing grant programmes. The Commission further proposes that, for each portfolio, all grant programmes with a value of less than \$5 million across the forward estimates should be consolidated with funding reduced by 15 per cent by 2015-16.

Agencies and bodies

There are too many government bodies in Australia. This leads to duplication and overlap, unnecessary complexity, a lack of accountability, the potential for uncoordinated advice and avoidable costs. There is no central repository of information on these bodies.

In considering the potential for rationalisation of bodies, the Commission has initially focused on the 194 principal Commonwealth bodies that operate under the *Financial Management and Accountability Act 1997* and the *Commonwealth Authorities and Companies Act 1997*.

Some 99 of these bodies warrant action. The Commission recognises that further investigation may be required regarding these suggested rationalisations.

Table 1: Rationalisation of Commonwealth bodies, authorities and agencies

Action to be taken	No. of bodies
Abolish	7
Merge with other bodies	35
Consolidate into the portfolio department	22
To be privatised	9
Review, with a view to merging, abolishing or transferring	26
Total number of bodies identified for attention	99

The Commission recommends abolishing seven bodies: the Australian Institute for Teaching and School Leadership Limited; the Australian Reinsurance Pool Corporation; the Clean Energy Finance Corporation; the Climate Change Authority; the Export Finance and Insurance Corporation; Innovation Investment Funds Investments Pty Ltd; and Low Carbon Australia Limited.

Among the opportunities for major consolidations of Commonwealth agencies, the Commission proposes:

- establishing a single, integrated border agency, to be known as Border Control Australia, through the merger of the border control functions of the Department of Immigration and Border Protection and the Australian Customs and Border Protection Service;
- consolidating crime intelligence capability by merging CrimTrac with the Australian Crime Commission; and
- consolidating Commonwealth health-related bodies by establishing a National Health and Medical Research Institute to better embed health and medical research in the health system. The Commission separately proposes that seven agencies within the Health Portfolio be consolidated into a new Health Productivity and Performance Commission. This new body should help to drive improved performance across Australia's health care system.

As well as the 194 principal bodies, the Commonwealth supports around 700 other bodies including boards, committees and councils.

The Commission has commenced a preliminary examination of these bodies and recommends each department reassess all committees, councils and boards within their portfolio with a view to reducing their number and associated overhead costs. In addition, the Commission recommends guidelines be introduced to govern the creation of any new government bodies and a central public register be established.

Improving government through markets and technology

The Commission has been asked to report on efficiencies and savings to improve the effectiveness of government through greater use of markets and technology.

The Commission recommends that a number of entities be **privatised** including in the near term: Australian Hearing Services; Snowy Hydro Limited; ASC Pty Ltd; and Defence Housing Australia. In the medium term the Australian Postal Corporation; Moorebank Intermodal Company Limited; Australian Rail Track Corporation Limited; Royal Australian Mint; and COMCAR should be privatised.

Within government, there is also scope to make better use of market mechanisms to drive efficiency and effectiveness, including **outsourcing, competitive tendering and procurement**. The Commission has made recommendations on improved guidance and standardisation regarding competitive tendering and procurement (to ensure value for money and best practice contracting models); and a whole of government user-charging framework.

The Commission has examined specifically outsourcing the **Government Payments System**. The Commission recognises that maintaining a welfare system is a core function of government. How payments are made and how people are assessed for eligibility is central to an efficient welfare system. Any decision to outsource the payments system must recognise this as well as other significant risks involved. These risks are amplified by the need to replace the existing information technology system that underpins the Government Payments System.

The Commission proposes the appointment of a highly credentialed business technology expert to oversee the development of the new payments information technology system in collaboration with the Department of Human Services. A scoping study on options for outsourcing all or parts of the Government Payments System should also be developed. Assessment of eligibility of recipients should remain within government.

The Commission has identified several areas where the Government could better harness **technology** to improve services and inform policy, including through greater use of **data analytics** and more assertive requirements to use cloud computing for non-core IT services. While progress has been made towards **e-Government** in Australia in recent years, the Commission considers that there is an opportunity to significantly accelerate the transition to digital service provision. The Commission accordingly proposes the Government commit to an ambitious ‘digital by default’ strategy that sets clear targets and removes barriers to digital services, and appoint a senior chief digital officer to drive change in the public service.

The Commission has also identified opportunities to improve the efficiency of corporate functions in the Australian Public Service, through standardising corporate business

processes, improving procurement of business systems, and the staged adoption of shared corporate services for appropriate groups of agencies.

Reform and restructure of the Australian Public Service

Throughout its deliberations the Commission has been provided with a range of views on the structure, performance and effectiveness of the Australian Public Service.

At the whole-of-government level, the machinery of government changes implemented in September 2013 have significantly simplified and streamlined arrangements.

However, a more efficient and effective public sector also requires appropriate structures within portfolios and within individual organisations. The quality of leadership and management within the public service is likewise fundamental to improving operational performance.

In its Phase Two Report, the Commission intends to examine in more detail issues associated with potential reform of the Australian Public Service, including the role of the Australian Public Service Commission.

The Commission will consider whether there are improvements to be made through:

- clearer accountabilities and better alignment of roles and responsibilities;
- increased spans of control and reduced layers of management;
- improved performance measurement and better performance management; and
- greater efficiencies in corporate and support functions across government.

Financial Implications

The Commission has made 64 recommendations across a range of activities and programmes, consistent with the objective of achieving a surplus of 1 per cent of GDP by 2023-24.

Most of our suggested actions go to the structural design of the biggest and fastest growing programmes. A detailed portfolio-by-portfolio review should yield further significant additional savings but insufficient to fix the underlying fiscal problem.

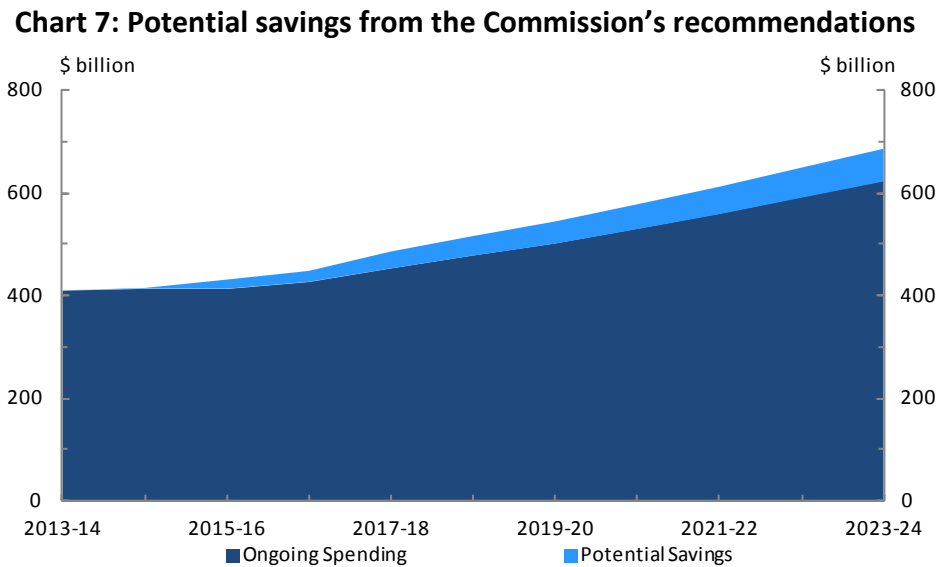
The Commission has prepared estimates of indicative savings from its recommendations. However, without decisions on detailed programme design and timing of implementation — which are matters for the Government — it is not possible to be definitive.

Detailed costings undertaken by Government as part of the Budget process would give greater clarity around the financial implications of the recommendations.

The Commission expects that these more detailed costings would yield modest savings in the early years rising to some \$20 to \$30 billion per year by 2017-18. By 2023-24, the savings could grow to some \$60 to \$70 billion per year.

These estimated savings do not factor in the additional savings from lower public debt interest costs arising from lower levels of Commonwealth debt which could be in the order of \$15 to \$20 billion per annum by 2023-24.

Chart 7 illustrates the potential magnitude of the savings.



It should be noted that the Commission has not included in its projections the Government’s commitment to increase Defence expenditure to 2 per cent of GDP.

Conclusions

The Commission supports the Government in its commitment to get the nation’s fiscal house in order.

This report has laid out a broad reform agenda that recognises the legitimate role of government and sets the Commonwealth Budget on a more sustainable path.

We have to restrain spending, rebuild our financial capacity and restore the buffer needed to shock-proof the economy from a future crisis.

The Commission has made 64 recommendations across a range of activities and programmes. These savings, or other savings of a similar magnitude, are needed to deliver a surplus of 1 per cent of GDP by 2023-24.

The aspiration is for more responsible government – to spend taxpayers’ money wisely and focus more on what governments should do, rather than on those things that citizens can best do for themselves.

The Commission believes that ‘business as usual’ is not a viable option for Australia. Unless we take action now, there is a very real prospect of an unprecedented run of budget deficits and a build up in net debt. This would place a significant burden on future generations to bring the Budget back under control.

Achieving the target surplus will require a significant reduction in spending, while holding to a discipline that taxes rise no higher than 24 per cent of GDP. The Commission’s proposals can be implemented incrementally and in a way that does not harm the economy. In fact, taken together they should strengthen the economy.

Australia needs to embark on a path of reform and renewal. Restoring the nation’s finances can be achieved through a concerted effort to restrain spending assisted by fiscal rules that set some reasonable boundaries around government.

Good government breeds confidence.

Governments that successfully manage their own affairs set an example to the rest of society about their ability to cope with economic and social challenges.

We must face up to the task.

Recommendations

Approach to government and new fiscal rules

Recommendation 1: Fiscal framework and rules

The imposition of clear fiscal rules and frameworks is one way of strengthening the nation's finances. The Commission recommends the Government adopt a high-level fiscal strategy which seeks to achieve underlying cash surpluses, on average, over the cycle; improve the government's balance sheet over time; and limit the size of government, as a proportion of GDP.

It should do this by adopting the following fiscal rules which set out how the fiscal strategy is to be achieved on a year-by-year basis.

- Achieve a surplus of 1 per cent of GDP by 2023-24.
- Substantially reduce net debt over the next decade.
- Ensure taxation receipts remain below 24 per cent of GDP.

Recommendation 2: Reporting against fiscal rules

To report the Government's adherence to the fiscal strategy, the Commission recommends the Parliamentary Budget Office report progress against the fiscal rules following the release of the Final Budget Outcome each year.

Recommendation 3: Better balance sheet management – unfunded superannuation liabilities

Unfunded superannuation liabilities on the Commonwealth's balance sheet represent a significant risk to the long-term financial position of the Commonwealth and should be better managed. The Commission recommends that the Government:

- a. close the Military Superannuation and Benefits Scheme to new entrants, with a new scheme established based on an accumulation plan opened for new Australian Defence Force members;
- b. as part of prudent financial management, move over time to a 'funded model' for existing defined benefit superannuation schemes; and
- c. in recognition of the upfront costs of a 'funded model' approach, consider allowing earlier drawdowns from the Future Fund to offset the costs of the new military accumulation scheme and future funding of existing defined benefit schemes. This would require amendments to the *Future Fund Act 2006*.

Recommendation 4: Better balance sheet management – loans and guarantees

There are risks to the Commonwealth's financial position when the government provides guarantees and loans. The Commission recommends:

- a. the expected costs of existing and new Commonwealth guarantees be included in the Contingency Reserve across the forward estimates (and removed from the Contingency Reserve at the end of each year if the costs do not eventuate);
- b. the expected non-repayment amount of loans be recognised as a grant at the time of loan origination;
- c. the expected costs be included in the Budget where they can be reliably estimated and have an expected cost above \$5 million in any year; and
- d. the Commonwealth continue to regularly and independently re-assess the value of its guarantees and loans.

Recommendation 5: Better balance sheet management – equity investments

Without commercial discipline, government-owned entities may accept a lower rate of return and take on excessive risk. The Commission recommends:

- a. the Commonwealth not take equity positions where the activity can be undertaken by the private sector;
- b. where the Commonwealth does take an equity position it should disclose the rate of return it expects to receive and how this compares to the risk-adjusted rate of return that a private investor would require to make the same investment; and
- c. the Commonwealth continue to regularly and independently re-assess the value of its equity investments.

Recommendation 6: Budget reporting and the Charter of Budget Honesty

Budget transparency allows for a more informed debate about the state of the Budget and fosters accountability. The Commission recommends improvements to the transparency of fiscal processes and budget reporting by requiring that:

- a. fiscal updates set out projections for key budget aggregates for 10 years beyond the Budget year;
- b. the Intergenerational Report be prepared within a specified period after the release of the National Census and that it be extended to also include analysis of the long-term sustainability of State and Territory budgets;
- c. fiscal updates should compare key economic forecasts and relevant consensus forecasts;
- d. sensitivity analysis in budget documents be improved;
- e. the Budget Process Operational Rules be released to enhance public understanding of how budgets are framed; and
- f. the Budget documentation give particular prominence to:
 - the underlying cash balance;
 - the Commonwealth's net debt position; and
 - the net financial worth of the Commonwealth.

Reforming the Federation

Recommendation 7: Reforming the Federation – clarifying roles and responsibilities

There is significant overlap between the activities of the Commonwealth and the States. The Commission recommends that a comprehensive review of the roles and responsibilities between the Commonwealth and State governments be undertaken, informed by:

- a. the principle of ‘subsidiarity’ so that policy and service delivery is as far as is practicable delivered by the level of government closest to the people receiving those services;
- b. ensuring that each level of government is sovereign in its own sphere; and
- c. ensuring minimal duplication between the Commonwealth and the States and, where overlap cannot be avoided, ensuring appropriate cooperation occurs at all times.

Recommendation 8: Reforming the Federation – addressing vertical fiscal imbalance

A closer matching of the revenue-raising capacity of States and Territories and their expenditure responsibilities would make them more responsible in their own sphere. The Commission recommends that:

- a. the degree of vertical fiscal imbalance in the Federation be substantially reduced. This should be achieved by providing the States with access to the Commonwealth’s personal income tax base;
- b. to facilitate this proposal, the Commonwealth should make room and reduce its personal income tax rate by an equivalent percentage point amount to a new State surcharge to ensure that taxes do not rise overall. Revenue raised would be hypothecated to the States; and
- c. the States be provided with a capacity to periodically vary the surcharge they impose as a means of injecting further competition into the Federation.

Recommendation 9: Reforming the Federation – arrangements for addressing horizontal fiscal equalisation

The practice of fiscal equalisation between the States is a central and longstanding feature of our Federation. The Commission recommends that, as part of a reformed approach to addressing vertical fiscal imbalance, new arrangements also be implemented to address issues with horizontal fiscal equalisation. This would involve:

- a. sharing all GST revenue on an equal per capita basis;
- b. the Commonwealth providing an additional grant to current recipient States to ensure that no State is worse off compared to the existing equalisation process; and
- c. distribution of the additional equalisation grant from the Commonwealth being determined by the Commonwealth Grants Commission.

Recommendation 10: Reforming the Federation – reduced tied grants to the States

Proposed changes to financial arrangements within the Federation should involve a transfer of responsibilities for areas of spending where the Commonwealth currently makes tied grants.

The Commission recommends that, should reforms be made to address vertical fiscal imbalance and horizontal fiscal equalisation as outlined above, existing tied grants from the Commonwealth to the States should be reduced by an amount equivalent to the additional untied revenue received by the States. Determining which grants would be reduced would be a matter for negotiation.

Recommendation 11: Reforming the Federation – Reducing the administrative burden

Steps need to be taken to simplify the large number of existing Commonwealth-State agreements and associated reporting arrangements. The Commission recommends:

- a. the administrative burden between the Commonwealth and State governments be substantially reduced by rationalising the number of National Partnership Agreements and streamlining and reducing reporting requirements; and
- b. the COAG Reform Council could be abolished with its reporting role and staff moved to the Productivity Commission.

Managing expenditure growth

Recommendation 12: Age Pension – establishing a new benchmark

The Age Pension is an essential part of Australia’s social safety net. The Commission recommends that changes be made to make it more sustainable by:

- a. changing current Age Pension indexation arrangements to a new benchmark of 28 per cent of Average Weekly Earnings and maintaining other price indexation arrangements; and
- b. transitioning to this arrangement, approximately over a 15 year period, by indexing the Age Pension maximum base rate at a rate equal to the higher of the growth in the Consumer Price Index or the Pensioner and Beneficiary Living Cost Index until it is equal to 28 per cent of Average Weekly Earnings.

Recommendation 13: Age Pension – tighter targeting of eligibility

The Age Pension is an essential part of Australia’s social safety net. The Commission recommends that changes be made in future to ensure it is more sustainable, affordable and better targeted by:

- a. formally linking the eligibility age of the Age Pension to 77 per cent of life expectancy at age 65 from 2033. This will result in the eligibility age for the Age Pension increasing to around 70 by 2053. The proposed change would not affect anyone born before 1965;
- b. replacing the current income and assets tests with a single comprehensive means test. Under this approach the existing assets test would be abolished with the income test extended by deeming income from a greater range of assets. The new comprehensive means test would apply prospectively to new recipients of the Age Pension from 2027-28 onwards;
- c. including in the new means test the value of the principal residence above a relatively high threshold. The threshold in 2027-28 would be equivalent to the indexed value of a residence valued today at \$750,000 for coupled pensioners and the indexed value of a residence valued today at \$500,000 for a single pensioner. This change would apply prospectively to new recipients of the Age Pension from 2027-28 onwards; and
- d. increasing the income test withdrawal (taper) rate from 50 per cent to 75 per cent. This change would apply prospectively to new recipients of the Age Pension from 2027-28 onwards.

Recommendation 14: Superannuation preservation age

The Age Pension and superannuation are interrelated elements of the retirement income system. The Commission recommends some changes be made to the superannuation system to complement changes being recommended for the Age Pension by:

- a. increasing the superannuation preservation age to five years below the Age Pension age;
- b. extending the current phased increase in the preservation age by an extra four years so the preservation age reaches 62 by 2027; and
- c. increasing the preservation age in conjunction with the Commission’s proposed increases in the Age Pension age thereafter.

Recommendation 15: The Commonwealth Seniors Health Card

The Commonwealth Seniors Health Card gives senior Australians who do not receive a pension, access to cash payments and concessions and discounts on certain products.

The Commission recommends that the Commonwealth Seniors Health Card be maintained as part of Australia's retirement income system, but that changes be made to improve targeting to those most in need by adding deemed income from tax-free superannuation to the definition of Adjusted Taxable Income used for determining eligibility for the Commonwealth Seniors Health Card.

Recommendation 16: The National Disability Insurance Scheme

The National Disability Insurance Scheme is a worthy scheme with widespread community support. The Commission recommends the Commonwealth continue to support the introduction of the National Disability Insurance Scheme, but that the scheme be implemented in a way which is fiscally sustainable by:

- a. pursuing a slower phasing in of the scheme recognising that this will require the re-negotiation of bilateral agreements with the States;
- b. amending governance arrangements to make the National Disability Insurance Agency a prescribed agency under the *Financial Management and Accountability Act 1997*, with the Chief Executive Officer directly accountable to the Minister;
- c. exercising budget control to ensure long-term financial viability;
- d. implementing contracting arrangements with the informal (not-for-profit) sector or other disability services bodies, including those operating in existing State schemes, to ensure contestability in the delivery of services to people with disabilities; and
- e. simplifying reporting arrangements to ensure transparency in the cost and efficiency of the delivery of disability services between the States.

Recommendation 17: Short to medium-term health care reforms

Australia's health system is not well equipped to face future challenges such as an ageing population and rising health services costs. The Commission recommends the Commonwealth Government pursue reforms to improve the health system as soon as practicable including:

- a. requiring higher-income earners to take out private health insurance for basic health services in place of Medicare; and precluding them from accessing the private health insurance rebate;
- b. the introduction of co-payments for all Medicare funded services, underpinned by a new safety net arrangement that would operate once a patient has exceeded 15 visits or services in a year. General patients would pay \$15.00 per service up to the safety net threshold and \$7.50 per service once the safety net threshold has been exceeded. Concession card holders would pay \$5.00 per service up to the safety net threshold and \$2.50 per service once the safety net threshold has been exceeded;
- c. implement arrangements to ensure that consumers are not able to insure against the co-payment and that medical practitioners who wish to bulk bill are not able to waive the co-payment;
- d. encouraging the States to introduce a co-payment structure for public hospital emergency departments for less urgent conditions that could be appropriately treated in a general practice setting;
- e. increasing the threshold for the General Extended Medicare Safety Net to \$4,000, while maintaining the Concessional Extended Medicare Safety Net threshold at existing levels. Safety net arrangements for Medicare and the Pharmaceutical Benefits Scheme should be retained to ensure support for people facing significant hardship, albeit with some adjustments;
- f. reviewing the Medicare Benefits Schedule to identify and remove ineffective items, replace expensive items with less expensive alternatives where available and investigate options for cost recovery for applications to list items on the Schedule;
- g. reforming the private health insurance market to provide greater incentives for efficient and cost effective health management through deregulating price setting arrangements, allowing health funds to expand their coverage to primary care settings, relaxing community-rating to allow health funds to vary premiums to account for a limited number of lifestyle factors, including smoking; and reforming the arrangements by which insurers equalise risks through the sector;

- h. limiting the Commonwealth's contribution to efficient growth in the cost of public hospital services to 45 per cent applying from 2014-15 and — with the exception of activity based funding — reducing the health reporting requirements significantly that the Commonwealth places on the States; and
- i. extending the current scope of health professional practices (for example, pharmacists and nurse practitioners) to address the future needs of Australia's health care system.

Recommendation 18: A pathway to reforming health care

Detailed work is required to examine opportunities to improve the efficiency and effectiveness of Australia's health care system over the medium to longer term. The Commission recommends the Minister for Health be tasked with developing options to reform Australia's system of health care.

The Minister should report to the Prime Minister in 12 months' time on progress and a preferred way forward.

Recommendation 19: The Pharmaceutical Benefits Scheme

The Commission recommends changes be made to the Pharmaceutical Benefits Scheme and to the pharmacy sector to improve this integral part of our health system through:

- a. the introduction of new arrangements for funding the Pharmaceutical Benefits Scheme within a set funding envelope that extends for a seven year cycle;
- b. establishing an independent authority ('PBS Entity') to be headed by a suitably qualified Chief Executive Officer who would oversee management of subsidised pharmaceuticals within the Australian health system and be required to report to the Minister for Health;
- c. permitting the Minister in exceptional circumstances to have new items listed by introducing a disallowable instrument into Parliament and on receipt of advice from the PBS Entity regarding items to be de-listed in order to offset additional costs;
- d. increasing co-payments for all medicines under the Pharmaceutical Benefits Scheme, including for concessional medicines that are currently free. This includes:
 - i. for general patients with costs below the safety net, a co-payment increase of \$5.00 (increase from \$36.90 to \$41.90), while above the safety net a rise of \$5.00 (from \$6.00 to \$11.00);
 - ii. in line with the increased co-payment arrangements, the general patient safety net should increase from \$1,421.20 to \$1,613.77; and
 - iii. for concession card holders, no increase to the current co-payment of \$6.00 while below the safety net threshold of \$360.00. However, once the safety net limit has been reached, concession card holders will be required to co-contribute \$2.00 to the cost of their medicines;
- e. opening up the pharmacy sector to competition, including through the deregulation of ownership and location rules; and
- f. streamlining approvals for new drugs through the Therapeutic Goods Administration process by recognising approvals made by certain overseas agencies.

Recommendation 20: Family Tax Benefits

In providing benefits to families there are trade-offs between the adequacy of assistance, targeting it to those in need and maintaining the incentive to work. The Commission recommends Family Tax Benefit arrangements be better targeted to those in need and simplified to boost workforce participation including by:

- a. changing arrangements for Family Tax Benefit Part A by introducing a new single means test, with the maximum rate of the benefit paid up to a family adjusted taxable income of \$48,837 and then phasing out at 20 cents in the dollar until the payment reaches nil;
- b. abolishing Family Tax Benefit Part B;
- c. introducing a new Family Tax Benefit Part A supplement to be paid to sole parent families who have a child under the age of eight. The supplement should be the same as the current maximum rates of Family Tax Benefit Part B (\$4,241 for a family with a child under five, or \$3,070 for those whose youngest child is aged five to eight years);
- d. changing the per child rates to be based on the current Family Tax Benefit Part A rates for a first child and paid at 90 per cent of this for second and subsequent children; and
- e. removing the Large Family Supplement and Multiple Birth Allowance recognising that the costs of children are sufficiently covered by the basic rates.

Recommendation 21: Paid Parental Leave

Paid Parental Leave has the potential to support maternal and child health and increase women's workforce participation. The Commission recommends:

- a. targeting expenditure to those most in need by lowering the Paid Parental Leave wage replacement cap to Average Weekly Earnings (currently \$57,460), indexed annually to movements in this wage; and
- b. savings from the lower wage replacement cap be redirected to offset the cost of expanded child care assistance, with the intent of making the changes broadly budget neutral, including retaining the 1.5 per cent levy on company taxable income above \$5 million per year.

Recommendation 22: Child care

The cost of child care significantly impacts on the ability of parents, particularly women, to participate in the workforce. The Commission recommends the Child Care Rebate and Child Care Benefit be replaced with a single, means-tested payment reimbursing parents for a proportion of their child care costs. The new payment should include a 'work, training, study' test and:

- a. should be broadly budget neutral and roughly maintain the current levels of assistance of around 80 per cent for low income families, with a base of assistance of 50 per cent available to all families;
- b. should include in-home care and other types of care that are not currently subsidised; and
- c. with savings from the Commission's proposed changes to the Paid Parental Leave scheme redirected to offset the cost of this expanded child care assistance, with the intent of making the changes broadly budget neutral, including retaining the 1.5 per cent levy on company taxable income above \$5 million per year.

Recommendation 23: Schools funding

While the Commonwealth does not have specific constitutional responsibility for school education, it provides significant funding to the States. The Commission recommends changing funding arrangements to simplify Commonwealth-State responsibilities and make school funding more affordable by:

- a. transferring all policy and funding responsibility for government and non-government schools to the States, with annual funding provided in three separate, non-transferrable pools - one each for government schools; Catholic systemic schools and independent schools;
- b. applying requirements on the States to:
 - i. publish how they allocate funds to schools;
 - ii. participate in national and international testing; and
 - iii. publish student outcomes on a consistent basis;
- c. basing Commonwealth funding from 2018 onwards on 2017 levels, with:
 - i. a 2017 per student funding amount calculated for the government and non-government school sectors in each State and Territory;
 - ii. annual funding for each sector in each jurisdiction calculated as the per-student amount, adjusted for the number of students enrolled in that year and indexed by a weighted average of the CPI and the relevant Wage Price Index; and
- d. significantly reducing the size of the Commonwealth Department of Education.

Recommendation 24: Defence

Ensuring the nation's defence and security is a core function of the Commonwealth Government. The Commission recommends a number of steps be taken to improve the efficiency, effectiveness, accountability and transparency of Defence spending through:

- a. ensuring preparation of the new Defence White Paper identifies capability options and associated costs for different sets of strategic risks. As part of this process, the Government should also assess the balance of strategic and fiscal priorities and how this compares with the commitment to increase Defence expenditure of 2 per cent of GDP within a decade;
- b. as a pre-condition for setting any new funding profile for Defence under the White Paper, the Government should ensure that Defence improves the effectiveness and transparency of expenditure by improving Defence budget arrangements and governance, capability development and delivery;
- c. transparency and control for government should be significantly improved by stronger budget processes including through the Expenditure Review Committee. For new capital, in particular new equipment projects, this would include holding funds in separate budget allocations and releasing them as projects are approved. Such expenditure should be treated as administered funding rather than departmental funding, so that there is greater financial control and scrutiny of this expenditure through established budget processes;
- d. a new ministerial directive to the Secretary of the Department of Defence and the Chief of the Defence Force specifying their separate and shared responsibilities and holding them individually accountable for Defence performance;
- e. reintegrating the Defence Materiel Organisation into the Department of Defence, with the size of the Defence Materiel Organisation being significantly reduced and with a renewed focus on contract management as opposed to project management;
- f. establishing a more professional Capability Development Group within Defence with an increased use of project development professionals skilled in cost and risk assessment;
- g. reducing the staffing size of Defence headquarters in Canberra, including senior staff, to 1998 levels; and
- h. Defence publishing performance indicators that reveal progress with reform, including the 'teeth to tail' ratio and the additional cost of unique and Australian built procurement decisions.

Recommendation 25: Aged care

With the ageing of the population, more Australians will be receiving some form of aged care support. The Commission supports the range of reforms currently being introduced in the aged care sector, but recommends additional measures be undertaken to improve the effectiveness and sustainability of the sector by:

- a. including the full value of the principal residence in the current aged care means test;
- b. implementing arrangements to allow older Australians to access equity in their principal residence, to pay for part of the cost of their aged care services;
- c. introducing a fee for aged care providers to access the accommodation bond guarantee or, alternatively, requiring providers to take out appropriate private insurance to cover the risk of default;
- d. terminating the Payroll Tax Supplement; and
- e. reducing duplication in all aspects of financial reporting for the aged care sector as well as reducing other regulatory requirements for aged care providers.

Recommendation 26: Carer payments

Many Australians care for a family member or friend who is unable to care for themselves. The Commission recommends payments to carers be maintained, but recommends changes to improve targeting including:

- a. limiting the annual Carer Supplement to only one payment per carer;
- b. introducing an income test for the Carer Allowance, set at \$150,000 per year;
- c. reviewing eligibility criteria applying to the type of care provided and to the needs of the adult receiving care. This should ensure that Carer Payment is targeted to those whose caring responsibilities limit their capacity to work; and
- d. aligning Carer Payment arrangements with the Commission's recommended changes to the Age Pension benchmark by transitioning to a new benchmark of 28 per cent of Average Weekly Earnings at the same time as implementation of the Age Pension benchmark changes.

Recommendation 27: Unemployment benefits

Unemployment benefits play an important role in assisting people back into work. Building on recent reforms, the Commission recommends a number of changes be made to improve incentives to work including by:

- a. requiring young single people aged 22 to 30 without dependants or special exemptions to relocate to higher employment areas or lose access to benefits after a period of 12 months on benefit; and
- b. increasing the income test withdrawal (taper) rate to 75 per cent for Newstart recipients and other related allowances.

Recommendation 28: The minimum wage

Australia's minimum wage is high by international standards. The Commission recommends that future growth in the minimum wage be contained to improve job opportunities. A degree of variation in the minimum wage should also be introduced across the States to better reflect local labour market conditions and the cost of living. This should be achieved by:

- a. establishing a 'Minimum Wage Benchmark', set at 44 per cent of Average Weekly Earnings;
- b. transitioning to this new benchmark by indexing the current national minimum wage to grow in line with the Consumer Price Index less 1 percentage point for a period of 10 years; and
- c. transitioning the minimum wage in each State and Territory to the lower of the 'Minimum Wage Benchmark' or 44 per cent of Average Weekly Earnings in that jurisdiction by 2023, noting that should this imply a reduction in the nominal minimum wage, the wage would instead be kept constant until aligned with 44 per cent of Average Weekly Earnings in that jurisdiction.

Recommendation 29: The Disability Support Pension

The Disability Support Pension provides support to those who are unable to work, or have limited capacity to work.

The Commission recommends the Disability Support Pension be maintained as an essential part of Australia's social safety net but that changes be made to ensure it remains targeted to those in genuine need by:

- a. moving to gradually apply the new disability assessment and participation criteria, introduced in January 2012, to targeted groups of grandfathered Disability Support Pension recipients such as those under the age of 35 and those with some work capacity; and
- b. changing Disability Support Pension arrangements to align with the Commission's recommended changes to the Age Pension by:
 - i. transitioning to a new benchmark of 28 per cent of Average Weekly Earnings at the same time as implementation of the Age Pension benchmark changes; and
 - ii. the Government considering when further changes should be made to the eligibility requirements for the Disability Support Pension, including replacing the current income and assets tests with a single comprehensive means test; including the value of the principal residence above thresholds of \$750,000 for coupled pensioners and \$500,000 for single pensioners in the new means test; and increasing the income test withdrawal (taper) rate from 50 per cent to 75 per cent.

Recommendation 30: Higher education arrangements

Commonwealth funding of higher education promotes quality and equity of access, while contributing to a more skilled and productive workforce. The Commission recommends a number of changes be made to existing arrangements to better account for the private benefits of higher education and improve performance of the sector including:

- a. decreasing the average proportion of higher education costs paid by the Commonwealth through the Commonwealth Grants Scheme from 59 per cent to 45 per cent and increasing the average proportion of costs paid by students from 41 per cent to 55 per cent;
- b. tasking the Minister for Education with developing options to increase competition in Australia's education system through a partial or full deregulation of fees for bachelor degrees, taking into account any relevant recommendations of the Review of the Demand Driven Funding System. The Minister should report to the Prime Minister in 12 months' time on progress and a preferred way forward;
- c. reducing the cost to the Commonwealth of the Higher Education Loan Programme by:
 - i. increasing the interest rate applying to HELP loans from the current rate (equal to movements in the CPI) to a rate which reflects the full cost to the Commonwealth of making the loan (incorporating the government borrowing rate, as well as the cost of bad debts and administration costs);
 - ii. increasing the repayment of HELP debt through reducing the threshold for HELP repayment from \$51,309 per year to the minimum wage of \$32,354 (with a low starting repayment rate of only 2.5 per cent);
 - iii. changing the indexation arrangements for the HELP repayment income threshold from movement in Average Weekly Earnings to movements in the CPI); and
 - iv. streamlining the five current HELP schemes, including removing SA-HELP and aligning administrative fee arrangements and incentive payments for early repayment.

Recommendation 31: Reforming foreign aid

Australia's overseas aid programme serves Australia's national interests, including by contributing to global efforts to reduce poverty and promoting stability and prosperity in our region. The Commission recommends Australia's Official Development Assistance programme be better managed including by:

- a. not tying aid spending to the level of Gross National Income, rather managing it in the same way as other agency funding, with any increase in resources justified in terms of the overall fiscal context rather than to a set of funding targets;
- b. increasing future aid spending at a rate no greater than the rate of inflation, noting that even with this funding, aid spending would be at historically high levels;
- c. reducing the significant fragmentation, with bilateral aid delivery tightly focussed on countries of strategic interest to Australia and with assistance to other countries addressed through the better performing multilateral funds; and
- d. focusing aid programme reporting on outcomes achieved rather than the quantity of resources applied.

Other programmes and spending

Recommendation 32: Industry assistance

Rather than relying on industry assistance, commercial discipline drives firms to reduce costs and improve quality to better meet customer demands. The Commission recommends significant changes be made to the approach to industry assistance in Australia including:

- a. limiting assistance to areas of genuine market failure and occasional transitional assistance to deal with genuine structural change. In all instances the benefit of government intervention must outweigh the costs;
- b. rationalising, phasing out, abolishing or reducing funding for 22 existing industry assistance programmes;
- c. amending Australia's anti-dumping system to include an improved public interest test so that dumping protection is only implemented if the benefits to the affected industry clearly exceed the costs to other industries and Australian consumers; and
- d. the Government continuing its drive to reduce the cost of doing business in Australia in such areas as labour market reform, deregulation, energy policy and provision of economic infrastructure.

Recommendation 33: Assistance to exporters

As the benefits of exporting accrue primarily to the business undertaking the activity, the Commission considers that there is scope to reduce current Commonwealth assistance for exporters by:

- a. abolishing the Export Finance and Insurance Corporation, ceasing funding for Export Market Development Grants, tourism industry grants and the Asian Business Engagement Plan, halving funding for Tourism Australia and significantly reducing the activities of the Australian Trade Commission (Austrade); and
- b. moving any residual functions of Tourism Australia and Austrade into a commercial arm of the Department of Foreign Affairs and Trade, with the existing loan book of the Export Finance and Insurance Corporation also transferred to the Department of Foreign Affairs and Trade to investigate options to on-sell or wind up the loans.

Recommendation 34: Research and development

The Commonwealth provides around \$9 billion per year to support Australian research and innovation. The Commission recommends the Government take a more strategic, whole-of-government approach to the funding of research and development, including by:

- a. abolishing sector-specific research and development programmes;
- b. reducing government support for Rural Research and Development Corporations to better reflect the mix of private and public benefits;
- c. consolidating existing research programmes aimed at fostering collaboration;
- d. aligning the Australian Research Council and the National Health and Medical Research Council grant processes;
- e. streamlining the current system of research block grants and postgraduate scholarships and looking at options for better aligning funding for the direct and indirect costs of research;
- f. committing to ongoing funding for critical research infrastructure in Australia, informed by a reassessment of existing research infrastructure provision and requirements; and
- g. allowing for more government oversight of the work of the Commonwealth Scientific and Industrial Research Organisation to ensure that resources are being directed to areas of greatest priority.

Recommendation 35: Indigenous programmes

Addressing the severe disadvantage faced by Indigenous Australians has rightly been a national priority of successive Commonwealth Governments. There is, however, significant scope to improve the effectiveness of Indigenous expenditure. The Commission recommends:

- a. significantly consolidating and rationalising Commonwealth Indigenous-specific programmes, bodies, committees, councils and boards, and ensuring programmes and reporting are focused on outcomes. The existing 150 or so Commonwealth Indigenous programmes and activities should be consolidated into no more than six or seven programmes;
- b. redirecting funds from administrative savings or the termination of less effective programmes to a new means-tested and needs-based voucher programme to assist Indigenous children with the costs of attending accredited education and training from early childhood through to primary school and tertiary education, including fees, travel and boarding costs;
- c. establishing over the next two to three years a new, separate agency for Indigenous Affairs reporting to the Prime Minister, with responsibility for Commonwealth Indigenous-specific programme delivery, development of a robust evaluation strategy and coordination with mainstream and specific providers at the Commonwealth and State levels;
- d. working directly with the States to establish new bilateral agreements which clarify and delineate responsibilities between jurisdictions, are outcomes based with clearly measurable performance indicators and involve pooled funding where appropriate; and
- e. reconfiguring mainstream services to ensure they are designed and delivered in collaboration with Indigenous people, with clear reporting requirements on access by Indigenous people and associated outcomes.

Recommendation 36: Resourcing diplomacy and consular activities

International diplomacy is a core responsibility of national governments. The Commission recommends steps be taken to improve the cost efficiency and effectiveness of the operations of the Department of Foreign Affairs and Trade and portfolio agencies including by:

- a. ensuring the planned review of diplomatic resourcing be undertaken by an independent reviewer rather than the Department, with the review re-assessing the need for embassies in high-cost locations and making greater use of arrangements to share resources overseas with like-minded countries;
- b. ending future involvement in international expositions, introducing fees for consular services, reviewing overseas conditions and allowances, rationalising Australia's memberships of international organisations and considering further outsourcing of passport production; and
- c. ceasing funding for the Australia Network and scaling back the International Relations Grants Program.

Recommendation 37: Drought assistance

The Commonwealth provides significant assistance to farmers through various drought assistance and farm finance initiatives. The new Farm Household Allowance scheme scheduled to begin in mid 2014 will exist alongside a concessional loan scheme for farmers. The Commission recommends that the Farm Finance Concessional Loans Scheme be abolished.

Recommendation 38: Housing assistance

Housing affordability and homelessness prevention are primarily the responsibility of State and Territory governments. The Commission recommends the Commonwealth:

- a. limit its involvement in housing to providing Rent Assistance payments;
- b. extend Rent Assistance to public housing tenants, provided State governments commence charging market rates of rent; and
- c. fund the increase in aggregate Rent Assistance payments by re-directing Commonwealth funding from existing agreements with the States for Affordable Housing and Homelessness and the National Rental Affordability Scheme.

Recommendation 39: Vocational education and training

Currently the States provide the vast majority of funding to the vocational education and training sector, with the Commonwealth contributing through tied grants to the States and some specific Commonwealth programmes. The Commission recommends that the Government wind back its involvement in the vocational education and training sector by:

- a. transferring policy and funding responsibility for vocational education and training to the States, with Commonwealth funding to be provided either as:
 - i. a single annual lump sum with minimum requirements for national reporting and quality assurance; or
 - ii. as part of a broader reform of federal financial relations;
- b. abolishing all Commonwealth vocational education and training programmes including the National Workforce Development Fund and Commonwealth support for apprentices; and
- c. requiring the States to continue reforms to achieve demand-driven vocational education and training outcomes and improve occupational licensing arrangements.

Recommendation 40: Mental health

Mental health services are characterised by overlapping funding and service delivery responsibilities and a lack of coordination across jurisdictions.

The Commission supports the proposed review by the National Mental Health Commission and recommends that the review pay particular attention to removing the significant duplication between the Commonwealth and the States that currently exists in mental health services.

Recommendation 41: Natural disaster relief

Recognising the primacy of State governments in dealing with natural disasters, Commonwealth involvement should be significantly reformed including by:

- a. replacing the Natural Disaster Relief and Recovery Arrangements with a grant in the case of each major natural disaster, with the Commonwealth contribution based on a designated proportion (between 25 per cent and 33 per cent) of the estimated reconstruction costs; and
- b. maintaining the Australian Government Disaster Recovery Payment but abolishing the Disaster Recovery Allowance with the Commonwealth's direct contributions being paid to only those individuals severely affected by natural disasters.

Recommendation 42: Community Investment Programme

There is scope for the Commonwealth to transfer responsibility for community development programmes to the States, the level of government closest to the people receiving the services. The Commission recommends that the Commonwealth transfer funding and responsibility for the Community Investment Programme to the States.

Recommendation 43: Visa processing

The Department of Immigration and Border Protection grants around 4.7 million visas every year. Many visa processing tasks are high volume and low complexity and would be well suited to outsourcing. The Commission recommends that a business case and scoping study for outsourcing the Department of Immigration and Border Protection's visa processing functions be prepared.

Recommendation 44: Employment services

The bulk of employment services are provided through Job Services Australia. The existing round of employment services contracts are due to expire in 2015. The Commission recommends the Government develop options to:

- a. improve the structure of employment services provided to the most disadvantaged jobseekers; and
- b. lower average costs per jobseeker under the post-2015 employment services arrangements, including by making greater use of technology in delivery of services.

The Commonwealth subsidy under Wage Connect is higher than similar wage subsidy programmes. The Commission recommends reducing the subsidy paid under Wage Connect to the levels available under similar programmes.

Recommendation 45: Efficiency of the public broadcasters

There is no right level of funding for the Australian Broadcasting Corporation and the Special Broadcasting Service as public broadcasters, or a right level of services that should be provided. However, there may be opportunities for greater efficiencies. The Commission recommends that:

- a. the ABC and SBS be independently benchmarked, both against each other and the commercial broadcasters, to determine whether it would be possible to achieve efficiencies and savings without compromising their capacity to deliver services including to remote and regional Australia; and
- b. future funding decisions in relation to the ABC and SBS should be informed by the outcome of the benchmarking exercise.

Recommendation 46: Containing costs associated with Illegal Maritime Arrivals

The detention and processing of Illegal Maritime Arrivals has been the fastest growing government programme over recent years. The Commission recommends that:

- a. by renegotiating contracts and better targeting of services, the per person cost of operating the onshore immigration network be reduced to 2011-12 levels and similar efficiencies be sought for the offshore network; and
- b. this process also be supported by an audit of the scope and cost of services currently being provided and how these have changed over time.

Recommendation 47: Fair Entitlements Guarantee Scheme

Where a firm enters into liquidation and is unable to pay employee entitlements, the Fair Entitlements Guarantee Scheme makes certain payments to eligible workers. It is important that employers meet their obligations to fund worker entitlements. The Commission recommends changes be made to the Fair Entitlements Guarantee Scheme to:

- a. introduce a cap of a maximum redundancy payment equivalent to 16 weeks' pay;
and
- b. limit the wage base for the scheme to Average Weekly Earnings.

Recommendation 48: Medical indemnity

Following the collapse of HIH Insurance and United Medical Insurance in the early 2000s, the Commonwealth has subsidised indemnity insurance premiums and provided assistance with high-cost claims. There is now evidence that the market is normalising. The Commission recommends the Commonwealth scale back its subsidies for medical indemnity insurance by:

- a. ceasing the Premium Support Scheme;
- b. ceasing the High Cost Claims scheme;
- c. considering grandfathering provisions to support the medical indemnity insurance industry in the transition to reduced Commonwealth subsidisation; and
- d. monitoring the impact on the medical profession, particularly in rural areas.

Recommendation 49: Grants programmes

The Commonwealth spent about \$22 billion on around 500 grants programmes in 2012-13. The Commission recommends significant changes be made to the administration of the Commonwealth's grant programmes including by:

- a. establishing a central register within the Department of Finance of all grants programmes with complete transparency on all grants awarded;
- b. reducing red tape for grant recipients by applying contemporary risk-based approaches to grant management;
- c. decreasing the number of existing grant programmes by abolishing, merging or consolidating existing grants programmes;
- d. addressing the proliferation of new grant programmes by introducing a rigorous grant assessment process at the approval stage; and
- e. ensuring all grants have measurable outcomes which are regularly assessed.

Rationalising and streamlining government bodies

Recommendation 50: Reduce the number of government bodies

There are too many government bodies. This can lead to duplication, unnecessary complexity and a lack of accountability. The Commission recommends that a significant rationalisation be undertaken of 99 Commonwealth bodies operating under the *Financial Management and Accountability Act 1997* and the *Commonwealth Authorities and Companies Act 1997* including by:

- a. reducing the number of existing bodies by 73, including those in Recommendations 51 to 54, by:
 - i. abolishing seven bodies;
 - ii. merging 35 bodies;
 - iii. consolidating 22 bodies into departments and agencies; and
 - iv. potentially privatising nine bodies; and
- b. reassessing the operations and continuing need for 26 other bodies.

Recommendation 51: Consolidation of border protection services

Border protection and security is integral to national security. The Commission recommends that a single, integrated border agency, to be known as Border Control Australia, be established through the merger of the border control functions of the Department of Immigration and Border Protection and the Australian Customs and Border Protection Service.

Recommendation 52: Consolidated crime intelligence capability

Criminal law enforcement is increasingly dependent on strong intelligence collection and analysis. The Commission recommends that CrimTrac be merged with the Australian Crime Commission to better harness their collective resources.

Recommendation 53: Consolidation of Health bodies

There are 22 bodies and agencies within the Health Portfolio, along with numerous associated boards, councils and committees. The Commission recommends that a significant consolidation of Commonwealth health related bodies be undertaken by:

- a. establishing a National Health and Medical Research Institute to better align and embed health and medical research in the health system;
- b. establishing a Health Productivity and Performance Commission by consolidating seven existing bodies to better coordinate, report and drive performance across Australia's health care system with a focus on measurable outcomes; and
- c. consolidating five other agencies into the Department of Health.

Recommendation 54: Single civilian merits review tribunal

The Commonwealth currently maintains four main bodies to review the merits of Commonwealth decisions. The Commission recommends that the Commonwealth civilian merits review tribunals (the Social Security Appeals Tribunal, the Migration Review Tribunal and the Refugee Review Tribunal) and the Classification Review Board be amalgamated with the Administrative Appeals Tribunal.

Recommendation 55: A central register and new guidelines for establishing bodies

There is currently no central register of Commonwealth bodies. Given the significant operating and governance costs of new bodies, the Commission recommends that:

- a. a central register of Commonwealth Government bodies be established and maintained by the Department of Finance; and
- b. new guidelines be established on the creation of new bodies recognising the primacy of ministerial responsibility and the role of departments, including requiring Cabinet agreement.

Recommendation 56: Reduce the number of boards, committees and councils

As well as the 194 principal bodies, there are around 700 other bodies including boards, committees and councils that the Commonwealth supports. The Commission recommends:

- a. each department reassess all bodies within its portfolio with a view to reducing their number and associated overheads, consistent with the criteria set out in Section 9.3; and
- b. all bodies, including boards, committees and councils be included on the central register of Commonwealth bodies.

Improving government through markets and technology

Recommendation 57: Privatisations

Twenty years ago, the Hilmer report highlighted the gains to the community from opening up government enterprises to competition. The Commission considers that Commonwealth bodies that operate in contestable markets should be privatised. The Commission recommends that the following 10 bodies be privatised over the short, medium and long term, in accordance with established practice.

Short term

- a. Australian Hearing Services.
- b. Snowy Hydro Limited.
- c. Defence Housing Australia.
- d. ASC Pty Ltd.

Medium term

- a. Australian Postal Corporation.
- b. Moorebank Intermodal Company Limited.
- c. Australian Rail Track Corporation Limited.
- d. Royal Australian Mint.
- e. COMCAR.

Long term

- a. NBN Co Limited.

Recommendation 58: Management of the Commonwealth Estate

The Commonwealth's property portfolio (the Commonwealth Estate) is diverse and of significant value. The Commission recommends that the management of the Commonwealth's property portfolio be strengthened, including by:

- a. establishing a central register of Commonwealth Estate properties within the Department of Finance;
- b. drawing on greater private sector experience in property management;
- c. undertaking a further divestment process to be overseen by an independent property expert; and
- d. continuing to use commercially available office and other accommodation as far as possible, ensuring there is competitive tension and value for money.

Recommendation 59: Outsourcing, competitive tendering and procurement

Governments should continue to harness the benefits of outsourcing where the benefits outweigh the risks. The Commission recommends that the Government:

- a. re-establish competitive tendering and outsourcing guidelines that reflect contemporary and best practice contract management processes;
- b. base procurement decisions on value for money at all times by abolishing Procurement Connected Policies;
- c. taking a more strategic and professional approach to procurement and contract management;
- d. make greater use of standardised contracts for procurement; and
- e. develop a whole-of-government user charging framework that improves efficiency, accountability and transparency.

Recommendation 60: Outsourcing of the Department of Human Services payments system

The Department of Human Services delivers over 200 different services for more than 20 Commonwealth and State agencies and is responsible for the Government Payments System. The system's supporting IT infrastructure is obsolete and arrangements are being made for its replacement. The Commission recommends that the Government:

- a. appoint a highly credentialed business technology expert to oversee the development of the new government payments IT system in collaboration with the Department of Human Services;
- b. establish a policy process to review and simplify the structure of welfare payments in parallel with the design of the new business information technology system; and
- c. develop a scoping study on options for outsourcing part or all of the Department of Human Services payments system.

Recommendation 61: Data

There is untapped potential to use anonymised data and new data analytic techniques to improve the efficiency and effectiveness of government. The Commission recommends that the Government, recognising the need to safeguard privacy concerns, rapidly improve the use of data in policy development, service delivery and fraud reduction by:

- a. requiring major departments and agencies to develop plans to maximise use of their own-source data;
- b. extending and accelerating the publication of anonymised administrative data;
- c. prioritising several 'big data' projects in major service delivery agencies; and
- d. establishing a data strategy to be prepared by the Australian Statistician on the quality, timeliness and availability of data that would be suitable for public release.

Recommendation 62: e-Government

e-Government services are often preferred by citizens, businesses and other government customers because they are more convenient and generally cheaper and more accurate. The Commission recommends that the Government accelerate the transition to online service delivery by:

- a. setting an ambitious digital strategy that:
 - i. makes myGov the default means of engaging with government, supported by 'opt-out' provisions;
 - ii. sets concrete savings targets;
 - iii. removes legislative barriers; and
 - iv. strengthens the myGov online credential;
- b. consolidating the e-Government effort through a single team under the leadership of a Chief Digital Officer; and
- c. appointing a senior minister to champion the digital by default agenda.

Recommendation 63: Cloud computing

Cloud computing is a way of leasing computing services over a network. It can reduce costs by sharing them across users. The Commission recommends that the Government increase its adoption of cloud computing by:

- a. introducing a mandatory 'cloud first' policy for all low risk, generic information and communication technology services; and
- b. establishing a whole-of-government cloud computing provider panel.

Recommendation 64: Corporate services and systems

All Commonwealth agencies perform common corporate functions, such as paying their employees and preparing financial statements. The Commission recommends the Government improve the efficiency of corporate services by:

- a. standardising corporate business processes;
- b. publishing a register of other business systems;
- c. improving procurement of corporate information and communication technology systems; and
- d. adopting a staged implementation of shared corporate services for Commonwealth Government departments and agencies.

**PART A: GOVERNMENT IN
AUSTRALIA AND THE STATE OF THE
FINANCES**

1 – What is this audit about and why is it needed now?

1.1 Introduction

Responsible government is a reasonable expectation in a civilised, democratic and prosperous society.

At the third session of the 1898 Federation Conference a delegate, who became our first Prime Minister, Edmund Barton proposed:

this Constitution is to be worked under a system of responsible government, a system which can only be applied where the power of the purse is in the Parliament.... but there is more than this in the Bill to ensure government by responsible Ministers.... that the power of the purse given to the Parliament is the guarantee of the retention of the people themselves of their sovereign right. It is the people who make these Houses; it is the people whose money is dealt with; it is the people who speak when a Ministry is turned out of office.... it is their voice also which says ... you should not have any more of our money to spend on reckless government.

The National Commission of Audit was established to examine the scope and efficiency of the Commonwealth Government, comment on the state of its finances and to advise on steps to ensure Australia's long-term fiscal strategy is responsible and sustainable.

There is a substantial budgetary challenge. Australia's budget situation is weaker than it should be and the outlook is ominous.

This Audit identifies actions that can be taken now to ensure that Commonwealth spending is placed on a more sustainable long-term footing. It recognises the unfairness of saddling today's children with our debts. With an ageing population there will be fewer people of working age to look after the retired. They should not inherit our debt as well as the burden of looking after us.

Securing the nation's finances includes issues extending far beyond the normal budget period. It is a long-term project for our whole society.

The extent of what is required over the next 10 years and beyond needs to be better understood by everybody. Politicians, commentators and the media generally have a role to play in ensuring that they understand and shape the debate in an informative way for Australians.

More importantly, we need to reconsider spending Australia cannot afford and be open to governments changing spending commitments as our national priorities change. Above all, governments must avoid promises that simply cannot be afforded over the long-term. Households understand they must live within their means. Governments must be no different.

1.2 Outlook for spending

In the current financial year, the Commonwealth Government will spend around \$409 billion, including \$95 billion in distributions to the States.

Of total Commonwealth spending in 2013-14 only 12 per cent (or just under \$50 billion) is categorised as agency and departmental spending. The remaining 88 per cent or some \$360 billion is classified as ‘administered’ payments. The vast majority of ‘administered’ payments are governed by legislation and established eligibility rules which mean there is little discretion as to whether they are made.

Looking ahead 10 years, any outlook for the Commonwealth’s finances will necessarily be inexact. It is difficult to estimate spending and revenue accurately in the near term, let alone out to 2023-24.

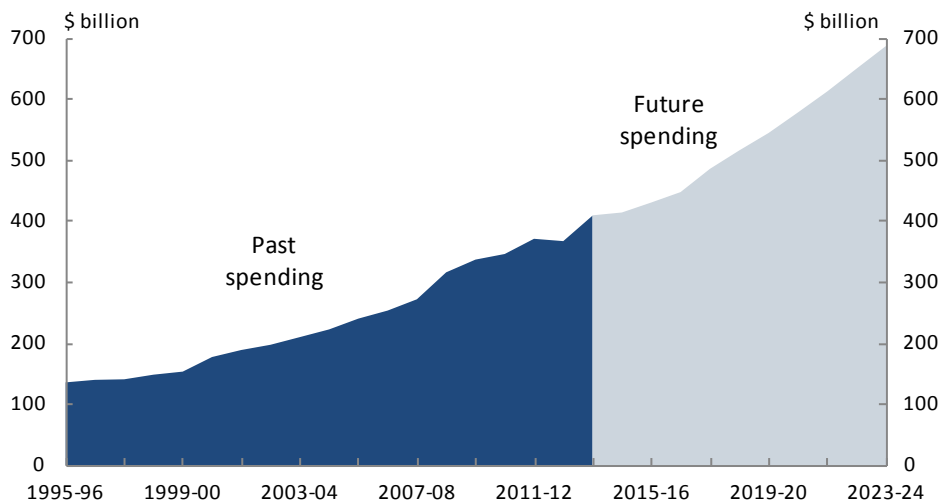
Nonetheless on the spending side it is possible to obtain a reasonable approximation of likely trends on the basis of what we know about expected population growth, demographic changes, the formulas used to increase payments each year and likely take-up rates for certain programmes.

Over the next 10 years Commonwealth spending is projected to increase by some \$280 billion to \$690 billion in nominal terms. Around 70 per cent of the projected increase in spending over this period is accounted for by growth in 15 major programmes (Chart 1.1).

The pace of spending growth is expected to accelerate considerably from 2017-18 onwards due largely to a step up in the rate of growth of Australia’s foreign aid programme and very substantial increases in expenditure in education and disability funding.

Annex B to this report outlines in detail the assumptions and methodology underpinning the projections. They involve assessments and judgements about various drivers of payments and are based on assumptions around economic growth and inflation that are reasonable and sensible.

Chart 1.1: Commonwealth spending



Source: Mid-Year Economic and Fiscal Outlook 2013-14 and National Commission of Audit.

1.3 The fiscal strategy and outlook

In recent years, Commonwealth spending has outpaced revenue collections. An underlying budget deficit of \$47.0 billion, or 3.0 per cent of GDP, is expected this year. This is the sixth consecutive budget deficit. We have spent beyond our means for too long.

At a time of continuing economic growth and emerging challenges arising from our ageing population, a prudent fiscal strategy requires the delivery of sustained budget surpluses. After years of growth and a sustained period of high terms of trade, Australia's fiscal position should be much stronger than it is.

A disciplined approach to fiscal policy is essential. Keeping the nation's finances under control allows a country to set an ambitious course for itself. A strong budgetary position is a pre-requisite for managing the volatility that arises from Australia's exposure to sudden movements in its terms of trade.

For the past 25 years there has been bipartisan support for fiscal policy guided by established rules and set with an eye to the medium term. This strategy is based on an approach of generating budget surpluses on average over the course of the economic cycle and reducing government debt. However, in recent years, the strategy was discarded.

Now the Abbott Government has stipulated a budget surplus equivalent to 1 per cent of GDP prior to 2023-24. The Commission regards this as a prudent, achievable and sensible goal. The Australian economy has enjoyed this degree of strength in the past. That strength provided us with a buffer against the global financial crisis.

With no further global or domestic shocks, a path to surplus will allow us to pay down our debt and over time eventually build reserves to better meet the next inevitable economic downturn.

Achieving this is a significant challenge given current spending commitments and recognising the recent relative weakness in Commonwealth revenue collections.

This Audit has not considered in detail revenue issues and reform of our complex taxation system, which are more appropriately dealt with in the forthcoming White Paper on Australia's Taxation System.

To assist in its deliberations, the Commission has prepared two illustrative fiscal scenarios - a 'Business as Usual' scenario and a 'Reform' scenario.

These scenarios provide high level guidance and should not be perceived as providing detailed projections.

A key assumption underpinning both scenarios is that substantially higher taxes are not used as the principal means of repairing the Budget. Instead taxes are assumed to recover in line with a growing economy to reach a share of GDP in line with historical averages (of 24 per cent of GDP). The tax share is then projected to remain at that level reflecting an assumption that additional tax collected from bracket creep is returned to taxpayers.

If adjustments are not made for bracket creep the Commission estimates that a person earning the average wage and currently facing a marginal tax rate of 32.5 per cent will be taxed at a 37 per cent marginal tax rate by 2023-24. The marginal tax rate for a person on the minimum wage would rise from 19 per cent now to 32.5 per cent well before 2023-24.

Given what we reasonably know about trends in Commonwealth spending, and holding to the cap on tax collections, the 'Business as Usual' Scenario would see the Commonwealth's Budget remain in deficit out to 2023-24 and beyond. If this eventuated Australia's taxpayers would be exposed to an unprecedented run of 16 consecutive years of deficits, with net debt rising to almost 17 per cent of GDP or \$440 billion in today's terms.

An alternative pathway that achieves a surplus will require a concerted effort to restrain spending with this restraint commencing within the next few years. This pathway would require unprecedented and consistent fiscal discipline and is reflected in the Commission's 'Reform' scenario. It projects a surplus of 1 per cent of GDP by 2023-24.

The Commission is not proposing a programme of austerity. Far from it.

Our recommendations can be implemented incrementally and in a way that does not harm the economy. In fact, taken together they should strengthen the economy.

Doing nothing is not an option. If these policy reforms are not undertaken now the size of the savings task will continue to grow and we will place an unfair burden on our children and their children. If we leave the task the future cost and disruption will be far greater.

By reducing expenditure, as well as red tape and compliance costs, government can make room for the private sector, which in many cases is better placed to deliver services more efficiently.

We must also recognise the primary role that monetary policy plays in keeping the economy strong. The current monetary policy stance will support businesses and the broader economy during this period of transition. Fiscal restraint by the government will help keep interest rates low over this time.

1.4 Spending and fiscal pressures within the Federation

Any consideration of the scope and efficiency of government must necessarily extend to the operation of Australia's Federation.

Australia's federal financial relations are characterised by shared roles and responsibilities, which have evolved over the past century. A consequence of these shared roles and responsibilities is duplication and overlap between the Commonwealth and the States and blurred accountability. This reduces the efficiency and effectiveness and fairness with which services are delivered.

There have always been substantial imbalances between the States' access to revenue bases and their expenditure responsibilities, including high demand services such as health care. The Commonwealth has always stepped in to fill the gap through the provision of grants to the States and more recently by providing revenue from the Goods and Services Tax.

These imbalances have significant impacts on the incentives and accountability of governments across the Federation. Furthermore, the extent of the imbalances has major implications for the capacity of State and Territory governments to address their own budgetary challenges. It is time to deal decisively with this situation.

Once the impacts of an ageing population and expected lower growth prospects in the longer term are taken into account a growing fiscal gap will emerge at all levels of government across Australia if current expenditure and revenue policies remain unchanged.

The change we face is stark. Today we have five people working for every one retired person, by 2050 we will only have 2.7. This means those 2.7 people working will need to produce as much as the 5 today just to maintain our standard of living.

By mid-century government expenditure allocated to health and ageing will account for over half of the Commonwealth's and the States' spending. Today, it's around a quarter.

There is no easy solution. Overcoming the challenge is not insurmountable but will require an integrated approach – a hard headed examination of spending, a preparedness to

embark on meaningful tax reform, a bold approach to recasting Commonwealth-State relations and, above all, a concerted reform agenda to support productivity and growth.

In the end, a strongly growing economy will provide a big part of the solution because through growth, wages and jobs are more abundant and taxation revenues are higher.

In undertaking the Audit and formulating its recommendations, the Commission has been guided by the importance of fairness, recognising that fairness has a strong relation to our sense of confidence and our ability to work effectively together. As a nation we are renowned for our sense of fairness.

Inevitably, vested interest groups will try to exempt themselves from shared sacrifice and common purpose, but they must reassess their expectations of government support in light of the overall good. National interest and not special interest must prevail.

It is only in this way that we can maintain a fair and cohesive society and afford the level of support to the deeply disadvantaged which is the hallmark of a truly civilised society.

The Commission has developed a set of common sense principles to guide its deliberations. These core principles have shaped the approach taken and helped the Commission formulate its recommendations.

Following them will ensure our fiscal goals can be achieved in a way the community understands and supports.

1.5 Principles of Good Government

1. **Live within your means.** All government spending should be assessed on the basis of its long-term cost and effectiveness and the sustainability of the nation's long-term finances.
2. **Harness the benefits of the Federation but demand a responsible Federation.** The Commonwealth's activities should be guided by the Constitution. The States and Territories should be free to compete amongst themselves, respecting the regional differences of a big continent. However, there will be occasions where the national interest calls for a cooperative and national approach.
3. **Protect the truly disadvantaged.** Government should protect the truly disadvantaged and target public assistance to those most in need.
4. **Respect personal responsibility and choice.** Government should not and cannot eliminate or insure every risk to the community. Personal responsibility and choice are fundamental to our democratic system.
5. **Assure value for taxpayers' money and ministerial responsibility.** Governments spend taxpayers' money not the government's money. They must assure value across all expenditure and constantly strive to improve productivity and eliminate waste. All programmes should be regularly assessed for effectiveness against their stated goals and outcomes. Ministerial responsibility is imperative and departments should be the primary source of policy advice.
6. **Be transparent and honest.** Transparency and honesty are fundamental to accountability. Government policy goals and programme outcomes must be transparent. Transparency in government will better illuminate the choices we face and the decisions needed for the overall good of the nation. Spending on lower priorities, however popular at the time, needs to be resisted.
7. **Reduce complexity.** Government should reduce complexity which impacts on its own operations, the operations of the States and Territories and the activities of the community and business. Reporting requirements should be kept to a minimum.
8. **Avoid regulation as a first response to a problem.** Adding new regulations to deal with problems should be the last resort and introduced only when existing laws prove inadequate and the risks of no regulation outweigh the costs to the community.
9. **Act in the public interest and recognise the benefits of markets.** In competitive markets, customers, not producers, take precedence. Competition and contestability drive lower costs, improve quality and give people what they want. Government should act in the public interest and only intervene in markets where market solutions fail to produce the best outcome for the nation as a whole.
10. **Do not deliver services if others are better placed to do it.** The delivery of public services should, wherever practicable, be handed to those organisations and levels of government closest to those receiving the service and should not be duplicated.

2 – The role of government

In Australia and around the world, there is a growing tension between what citizens want their governments to do and what governments can or should do.

Governments have a rightful role to play in society but they are a supplement, not a substitute for markets. A market-based society with a meaningful role for government is a proven way of boosting living standards, increasing well being and ensuring equity while ensuring hard work, risk and innovation receive their just reward.

Governments shape the way societies and economies function and meet the needs of our national interest. Regrettably, the community's expectations have run ahead of what can be afforded. In the face of increasing calls for new spending and new programmes, there has been insufficient focus on the need to revisit spending priorities elsewhere or examine alternatives such as reducing costs or raising taxes.

Governments have the power to tax, spend and regulate although they are subject to limits imposed by law and the democratic process. Governments can also play a significant role in bolstering the economy's productive capacity and in building human capabilities, by funding education and social services and supporting the community's creative endeavours.

Governments should aim to improve the incentives and widen the choices available to people and businesses. They also have an essential role in promoting an environment that fosters growth and prosperity.

2.1 What do Australians expect their governments to do?

Australians believe governments can and should play an important role in the functioning of society.

Australians expect their governments to set and maintain sensible laws and provide for law and order. Australians expect the government to take responsibility for the defence of the nation, for national security and for protecting our borders.

Australians see governments as having a central role in providing access to essential services such as basic health and education, especially for children. They look to governments to provide important infrastructure such as roads, railways and bridges.

Australians expect their governments to step in to deal with situations where the actions of some impact negatively on others. This includes interventions to prevent such things as drink driving or smoking in public amenities, to protect children and to regulate activities that might lead to environmental degradation.

As well as addressing market failures, Australians expect governments will provide a social safety net which helps protect the poor, the vulnerable, the elderly and the truly disadvantaged. This is the Australian way.

Fairness and equity also matter a great deal to Australians and we accept government has a role to play in redistributing income. A progressive tax system combined with a targeted welfare system is the best way of addressing income distribution and Australia has been a world leader in this since Federation.

Australians look to their government to pursue sound economic management to help keep the economy strong. They also look to their governments at times of major economic crisis. While there may be debate as to the volume and quality of government spending during the global financial crisis, there is no doubt the economy needed a boost. With so little debt at the time, the Government was able to act.

Australia has one of the world's most open economies and we accept the significant benefits that come from being a competitive and open trading nation. Increasingly, however, our national priorities and identity can be at odds with the global nature of markets. Australians expect their governments to protect our own social arrangements when this might conflict with the requirements imposed on us by globalisation.

Australians look to their governments to reduce the overall risk in society. Many look further, wanting governments to either solve all of society's risks or protect them from the inherent risks of everyday life.

Australia is a diverse country and Australians have different views on the optimal size and role of governments. These views more often than not come down to value judgements. But once judgements are made on what services and protections government should provide, decisions are required on who pays – whether by taxes, charges or other user-pay arrangements.

This must recognise, however, that taxes and charges can have a dampening effect on economic vibrancy and thus reduce a government's capacity to fund needed services.

2.2 What should governments do?

Many of the things Australians expect from government have a strong foundation – both on an economic and social basis.

However, it is not always apparent where the boundaries lie or where new boundaries should be drawn when it comes to government intervention. Trade-offs and value judgements will inevitably have to be made and the financial capacity of government provides a limit to what it can provide.

There is no better way of improving services than by giving consumers real choice. In competitive markets customers take precedence. The pressures and constraints that arise from having to obtain and satisfy customers create strong incentives to control costs, improve quality and develop new and better ways of doing things.

There are instances when markets cannot do what is needed and governments have to intervene. In doing so they must strike the right balance. Government interventions should be justified on the basis that they produce net sustainable benefits that improve the wellbeing of the community. There is a need to be aware also of the potential for government interventions to crowd out the private and non-government sectors from activities that they may be more capable of providing.

Efficiency and effectiveness

Governments should always strive to be effective and efficient in achieving the clearly stated objectives of their programmes and policies with specified outcomes and transparent monitoring and reporting.

Ensuring government services are produced and delivered at the lowest possible cost is desirable as it releases funding for more services or other priorities.

Efficiency also requires resources to be allocated properly over time – taking account of better products and ways of doing things and making the most of new technologies.

Governments should aim to identify the most efficient option – the policy, programme and outcome that results in the highest net benefit to the community as a whole. Governments need to constantly question whether there is a better or more efficient way of achieving objectives.

We must accept that gains in efficiency — not just in government but in the private and non-profit sectors — will improve the community's wellbeing and raise standards of living. We are all better off when our dollars are working hardest for us.

The work of the Productivity Commission, for example, is focused on achieving gains in efficiency in support of the overall national interest.

Improving efficiency can involve reducing the costs of production for each unit of output produced but, equally, might be achieved by better matching the supply of goods and services to those things people want most or by removing barriers to innovation and flexibility.

Cost-effectiveness is particularly relevant to public policy. It requires a focus on direct programme costs, including administration. However, this approach will not always work when the options to achieve desired policy outcomes are not necessarily comparable. In

aged care for example, it can be difficult to compare the cost effectiveness of home-based care (including the informal role of carers) relative to the formal residential care option.

Managing the economy for growth and stability

The Commonwealth Government should play a substantial role in maintaining the stability of markets and endeavouring to manage the overall economy. Its aim should be to foster long-term economic growth and economic stability, including keeping unemployment and inflation low.

Governments can have an important influence on the incentives that affect innovation, investment and decisions on whether to participate in the workforce – all fundamental drivers of growth. Incentives are also influenced by the disciplines imposed by competitive markets.

Management of the economy is made easier by having a sound policy framework including an independent central bank with responsibility for setting monetary policy.

A government's approach to fiscal policy is also critical to imparting certainty and credibility to markets through the application of sound macroeconomic policies. Credibility in policy making contributes to reduced uncertainty and creates a more attractive environment for business. A disciplined fiscal policy with credibility over the medium term allows business to make investment decisions with greater confidence.

Good policy sets the markers by which we can get our bearings for the future.

Fiscal policy should be set over the medium term. Budget decisions will naturally vary from year to year in line with economic conditions and a government's plans. However, for the most part, fiscal policy should not be used to fine tune the economy.

Fiscal policy should be used effectively at times of major economic shocks and downturns to lessen the negative impact on economic activity and thus reduce unemployment. As the international economic environment becomes more volatile and as Australia becomes more exposed to movements in global commodity prices the risks of such shocks are likely to rise.

In order to effectively manage extreme economic and financial circumstances, governments should create capacity through prudent fiscal management in normal times.

Having a strong budgetary position for many years before the global financial crisis enabled Australia to withstand its economic impact.

Protecting the balance sheet

As well as pursuing a disciplined approach to fiscal policy through prudent spending and taxing decisions, it is also important for governments to keep their balance sheets strong.

For governments, as with companies, a strong balance sheet is important. The state of the balance sheet is a key determinant of borrowing costs for government. Repairing poor balance sheets typically requires higher burdens on taxpayers and reductions in government services.

Liabilities on the balance sheet (including government debt) also have to be serviced and repaid, which reduces government's capacity to fund other services.

Where governments have a strong balance sheet, they are able to use it to support the national interest. For example, the provision of banking guarantees during the global financial crisis.

Governments should be conscious that the provision of government guarantees is not without risk. If a government guarantee is drawn down then the balance sheet of the government can be weakened considerably.

Approach to equity, fairness and disadvantage

Alleviating the impact of poverty and providing people with an opportunity to escape it are essential functions of governments. This is particularly the case for children.

Nonetheless, there are diverse views on the appropriate extent of government help to families and people in poverty.

The provision of taxpayer funded assistance payments has been and should continue to be an important public priority. Their primary purpose should be to ensure a minimum, adequate standard of living for people who are unable to support themselves through work or their savings.

Rates of assistance payments, including their adequacy, should be balanced against their impact on incentives for people to get off welfare and into the paid workforce. Being able to provide for yourself or at least contribute to your own welfare is a vital part of the freedom and independence many take for granted. Payments also need to be seen as affordable, sustainable and fair by the community.

Assistance should be means tested to target those in greatest need.

Through the National Disability Insurance Scheme the Government intends to substantially expand public services to Australians with disabilities. The scheme has widespread

community support and reflects a judgement that government should provide a form of social insurance for disability.

As well as the challenge of managing their disability, people with disabilities often face social exclusion and poor employment opportunities and outcomes. The scheme is also intended to improve the wellbeing of family members and carers, who often must leave employment to care full time for a relative with profound disability.

Over time, economic conditions and the characteristics of society change and it is accordingly important to ensure the objectives of welfare payments, as well as their rates and the means tests for eligibility, remain relevant and affordable.

Adding to productive capacity

Governments should also support economic growth and wealth creation by helping to boost productive capacity. Governments can influence the quality and productivity of the labour force and improve access to economic and social infrastructure to enhance Australia's global competitiveness.

Access to basic health and education is critical for people to reach their potential, to engage in the workforce and to make a productive contribution to society. To ensure as many people as possible in society have access to good health and education, governments are involved in funding or providing these basic services.

Quality education and training, provided through the university and vocational education systems, support people in their working lives by equipping them with needed skills and competencies. As well as supporting Australia's economic competitiveness, education is a key driver of social mobility, economic prosperity and social cohesion.

More broadly, policy settings through the tax and welfare system impact on work incentives and should be framed in a way that avoids discouraging people from seeking paid employment.

The Commonwealth also determines the size and composition of Australia's migration intake, which adds to Australia's labour supply and long-term productive capacity. Since 1945, around 7 million migrants have settled in Australia bringing qualifications, skills and experience that are in demand.

Governments provide, fund and regulate economic infrastructure such as energy, road, rail and port facilities. The availability and quality of this infrastructure feeds directly into the cost structure of Australian businesses, impacting on productivity and the ability of local firms to compete in international markets.

Regulatory interventions

The community benefits from good regulation that supports the effectiveness of markets. Good regulatory interventions get the balance right, recognising the roles played by the formal rule of law and the discipline of a business's own reputation.

Governments should aim to make regulation more efficient and effective by clearly setting out the reasons for new regulations. The process and a commitment to rigorously follow good process are essential.

Often regulatory proposals are accepted despite regulation not being the most effective mechanism to manage the risk. Governments often want to be seen to be doing something. This approach can result in an over-reaction to the problem and place a major cost on the community and business without addressing the underlying risk in the most sustainable and cost effective manner.

For example, many retailing businesses are forced to operate under different regulatory regimes that restrict their competitiveness and ability to innovate. These regimes include planning and zoning, retail tenancy regulation, transport restrictions, retail trading hours, workplace relations and a range of inconsistent state-based regulation.

The impact of this is to increase prices and reduce choices for consumers at a time when there is increasing competition from on-line businesses.

A commonsense approach to handling risk in society

Governments step in at times to reduce risk in society. Clearly they have a role when it comes to dealing with catastrophic events that impact on individuals or on whole communities, for example in the aftermath of natural disasters such as major floods, cyclones and bushfires.

However, government should not take on risk for the community unless it is better placed to manage the risk. In Australia and most societies, individuals and markets best handle the majority of risks.

Families should be the prime social institution for dealing with risk. Parents provide for their children and many people rely on family and friends to look after the sick and disadvantaged. Inheritance transfers family assets between generations.

Australia has private markets that provide various forms of insurance including home and car insurance to protect against accidents and property damage and injury. There is a strong and vibrant health insurance market in Australia.

Against this backdrop, governments should not act as the insurer of first resort. Governments should help families and individuals manage risk on their own behalf.

Similarly businesses should manage their own risks, including the risk of losing customers or falling behind as they face greater competition.

Government actions can also introduce or increase risks. Policies may have unintended consequences and poor economic management may reduce business and consumer confidence. Fiscal and tax policies which lack credibility or change the rules cause uncertainty and add to the risk of existing and future investments. Poor or unpredictable regulation also adds to risk.

Unsustainable fiscal policies pursued by governments represent a substantial risk for any country and its citizens. Equally, well managed finances and responsible, disciplined fiscal policy reduce risks.

In dealing with risks in society, governments should acknowledge eliminating all risk is both unattainable and undesirable. The community should not expect a risk-free life.

3 – What do governments do in Australia today?

This chapter provides a snapshot of what governments do in Australia. It outlines the breadth of services provided, together with how governments go about providing them. It also looks at how Australia’s federal system and the current system of Commonwealth-State financial relations operate.

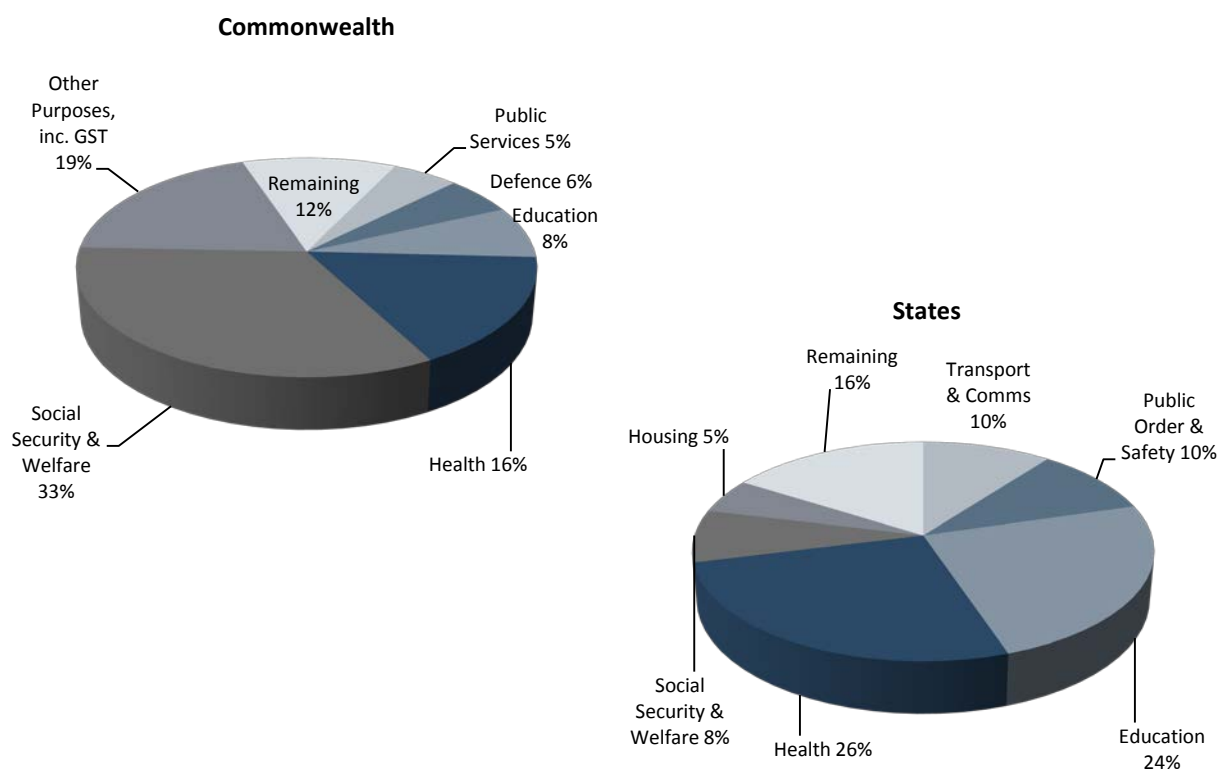
As such, it raises issues Australians must address to increase our Federation’s effectiveness and allocate responsibilities, and funding for them, to the best-equipped level of government.

3.1 What do governments do and who does what?

Today, the Commonwealth and State governments spend over \$500 billion in delivering services to Australians.

Australia’s Constitution and federal system dictates the level of government which delivers various services.

Chart 3.1: Government spending



Source: Australian Bureau of Statistics Cat No. 5512.0.

Australia's Constitution provides the basic rules for government. It was conceived and approved by Australians and established a federal system which distributed powers between a new central government and States.

The Constitution (particularly section 51) confers powers to the Commonwealth Parliament to only make laws in specified areas including defence, external affairs, interstate and international trade, taxation, foreign affairs, trading and financial corporations, marriage and divorce, immigration and interstate industrial conciliation and arbitration.

The list of Commonwealth powers in the Constitution does not specifically refer to a number of important areas such as education, the environment, criminal law and roads. However, this does not mean these subjects are outside its authority.

The Constitution does not confine the matters about which the States can make laws. Accordingly State parliaments are able to legislate on a much wider range of subjects than the Commonwealth Parliament. This is why important areas such as education, crime and roads are regulated primarily by State rather than Commonwealth law.

Although States can pass laws on a wider range of subjects than the Commonwealth, the national government is generally regarded as the more powerful partner.

A principal reason for this is section 109, which provides that where there is an inconsistency between Commonwealth and State laws, the former prevails.

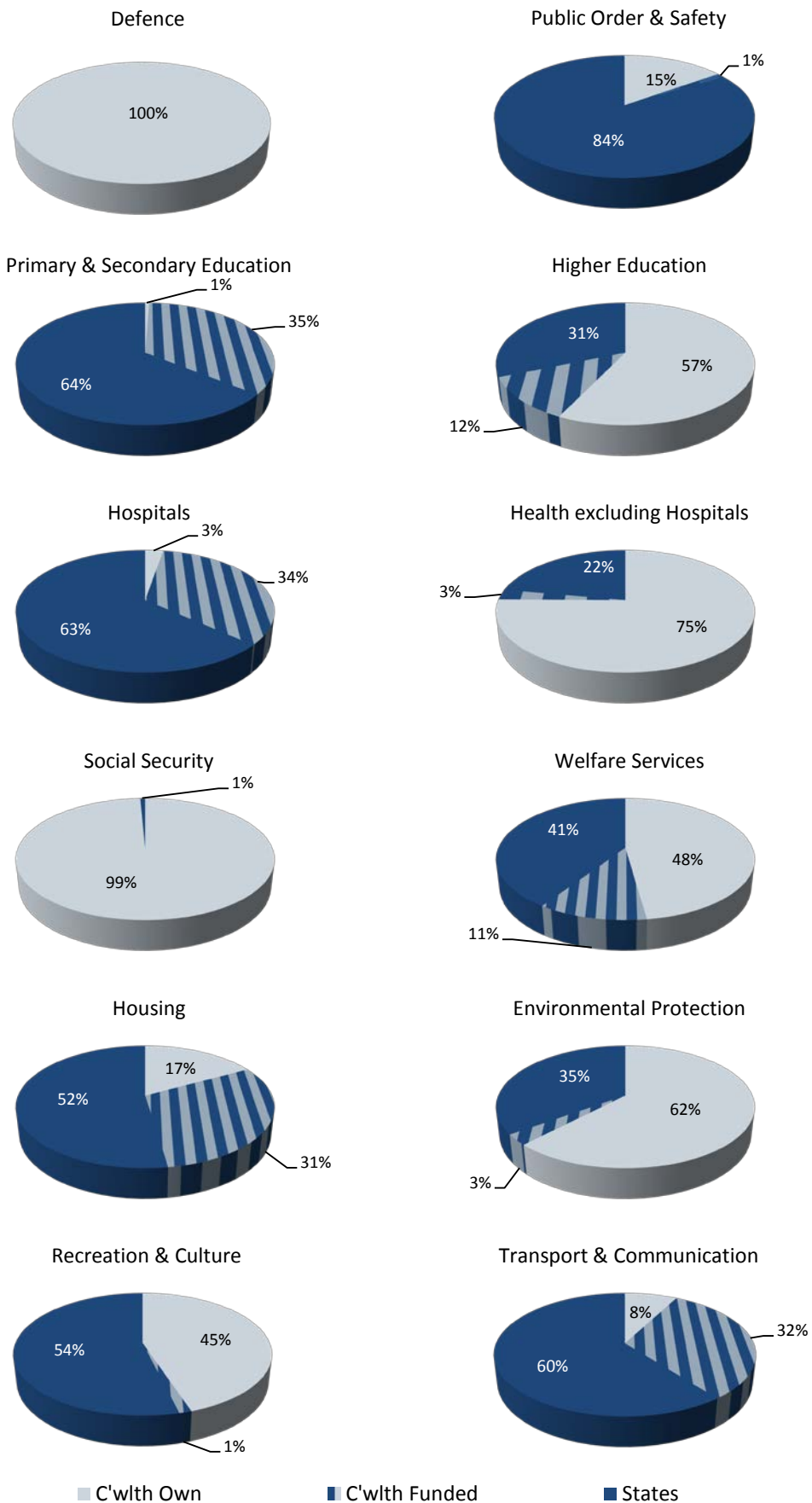
Traditionally the States have not raised sufficient revenue to perform all their functions. Consequently they receive grants from the Commonwealth, many without conditions.

Section 96 of the Constitution allows the Commonwealth to make conditional grants of money to the States for any purpose. This power allows the Commonwealth to influence the way things are done in areas where it has no direct power to pass laws.

The shared roles and responsibilities between the Commonwealth and the States are problematic. They increase the risk of administrative duplication and overlap, higher administrative costs and cost shifting. They are a fertile ground for reduced efficiency, effectiveness and fairness of service delivery.

Chart 3.2 below illustrates the current division of effort in identified areas of government. The grey portions show the level of Commonwealth effort and the dark blue portions show that of the States. The States' component is further broken down into those amounts that are funded by them directly and those funded by the Commonwealth through tied payments to the States.

Chart 3.2: Spending on selected functions of government



Source: Australian Bureau of Statistics Cat No. 5512.0.

As the charts above demonstrate, there are numerous spending areas with significant Commonwealth and State overlap and numerous areas where the Commonwealth provides tied funding to the States to deliver specific outcomes or policies.

The division of responsibilities often raises significant problems and contributes to a less functional Federation. This includes poor coordination of planning and service delivery and a lack of accountability over the quality and cost of services provided.

In health for example, the Commonwealth has responsibility for primary health care (including doctors and pharmaceuticals) while the States have responsibility for managing public hospitals.

Complex funding arrangements between the Commonwealth and the States are in place for public hospitals resulting in a lack of clarity when it comes to political responsibility and accountability.

Problems with the division of responsibility mean that cost shifting often occurs between governments. Patients discharged from State government run public hospitals are often referred to their local general practitioner who is subsidised by the Commonwealth. Separately, a lack of Commonwealth funded aged care places in a particular area can result in public hospital beds being inappropriately occupied by elderly people.

Significant overlap between the Commonwealth and the States exists in relation to the provision of mental health services.

The States operate public schools on a day to day basis including running their own systems and regulating non-government schools. While the Commonwealth does not have specific constitutional responsibility for schools it has, since the 1970s, taken an increasing role in schools funding.

The provision of vocational education and training has traditionally been a State responsibility, however the National Training System is jointly provided by the Commonwealth and States.

There is considerable duplication and bureaucracy in the provision of early childhood services. Childhood education and child protection services are provided by the States. However, the Commonwealth is also in this space running its own programmes to prevent child abuse and neglect.

Government funding for the universities sector is the responsibility of the Commonwealth yet the States retain an involvement, including their own legislative framework, owning the land on which the universities operate and having responsibility for making appointments to university senates.

In the area of housing, the Commonwealth has no constitutional power. The States take the lead in the provision of public housing and, along with community based organisations, in addressing homelessness. Nevertheless, the Commonwealth spends a significant amount on housing through rent assistance and through direct payments to the States for affordable housing and alleviating homelessness.

Commonwealth and State governments both direct significant funding towards Indigenous affairs, through both mainstream and Indigenous-specific programmes and services. While funding is almost equally split, there is substantial overlap and duplication in Indigenous programmes provided by the Commonwealth and the States. In the town of Roebourne in Western Australia for example, the 1,150 predominantly Indigenous residents are serviced by some 400 different programmes funded variously by both the Commonwealth and State governments.

Australia's environmental regulatory framework contains numerous overlapping, excessive and inconsistent requirements between the different levels of government. The Constitution contains no specific powers for the Commonwealth to legislate on environmental or planning matters with the States having an ability to legislate on a broad range of matters, including the environment and cultural and natural heritage.

However, the Commonwealth uses other constitutional heads of power to regulate in this area and matters of national environmental significance now trigger the operation of the *Environment Protection and Biodiversity Conservation Act 1999*.

Australia's governments provide much of the nation's economically essential infrastructure including roads, rail networks and ports. Major investment decisions with respect to public infrastructure are predominantly taken by State governments and most infrastructure is owned by the State. However, substantial expenditure on infrastructure is funded through Commonwealth payments to the States. There is significant institutional and regulatory duplication on infrastructure matters between the Commonwealth and the States.

The responsibility and costs associated with repairing infrastructure damaged in natural disasters accrue mainly to the relevant State government. However, the Commonwealth provides financial assistance to the States to assist with these costs, with funding determined by the claims submitted by the States in line with a designated formula.

3.2 The operation of the Federation

Australia's federal model has a number of distinctive characteristics including the relatively high degree of shared functions between governments. Over time, there has also been a trend towards greater Commonwealth involvement in the nation's affairs.

Throughout our history debate has persisted on the efficacy of the Federation recognising that many practical difficulties arise through its operations. Overall, however, the Commission believes that the Federation has served us well.

One of our leading historians, Geoffrey Blainey, has explained why a federal system is best for Australia:

It is highly democratic. It is a guardian of civil liberties, because it offers a balance of powers rather than one supreme power. It is close to the people but also Olympian at times. It enables specialisation, and it respects the regional differences in a big continent. But it is not a neat package of powers. Tidiness is not amongst the visible strengths of a federal system. There will always be ragged edges and compromises, there will always be tensions in a federal system. There will periodically be formal or guerrilla raids across the federal-State boundaries, usually led by national leaders. The raids now and then are led by Justices of the High Court.

It is fair to suggest that it is not an easy system for politicians to operate in... If three spheres or levels of government carry out the same activity, say in health or social services or education, then the bureaucratic and administrative expenses may well be too high. And if things go wrong, whom do we blame? Praise and blame form the gearbox of democracy. It is vital that a government responsible for creating chaos, or letting chaos reign, should be pinned down.

Address to the Samuel Griffith Society, 2007

A feature of the Australian Federation is the extent of the imbalance in the revenue raising capacities and spending responsibilities of the different tiers of government.

The vertical fiscal imbalance that exists reflects the fact that the Commonwealth Government raises revenues in excess of its spending responsibilities, while State governments have insufficient revenue from their own sources to finance spending responsibilities.

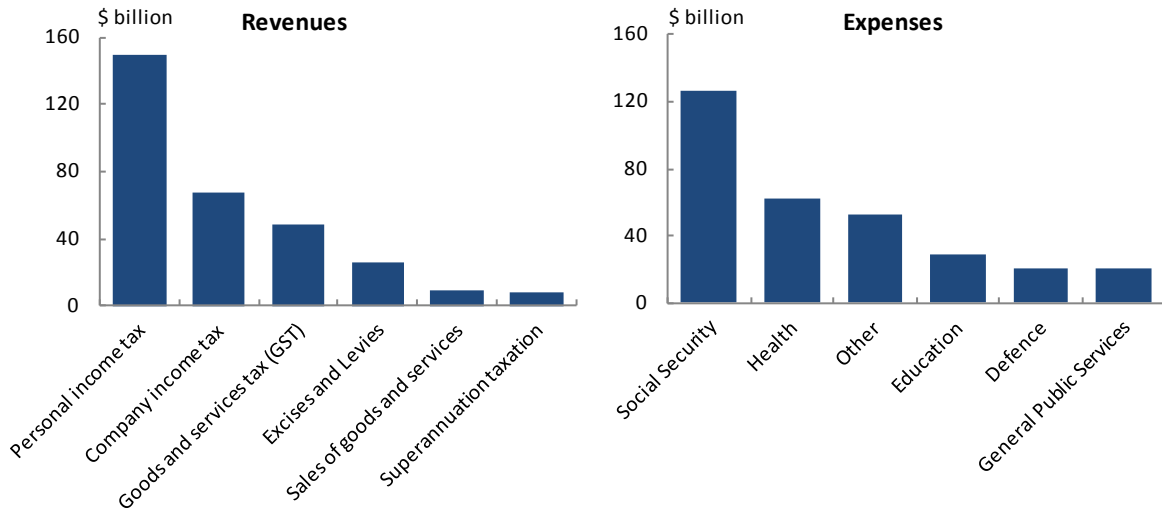
The amount of money provided by the Commonwealth to meet this revenue shortfall by the States is currently around \$96 billion per year.

Of this, \$51 billion comes from untied funds - passing over the \$50 billion proceeds of the GST which the Commonwealth collects, plus another \$1 billion in general revenue assistance. A further \$45 billion is in the form of direct grants, which can be tied to a general area of spending, or to meeting specific criteria, or to provide a very specific outcome.

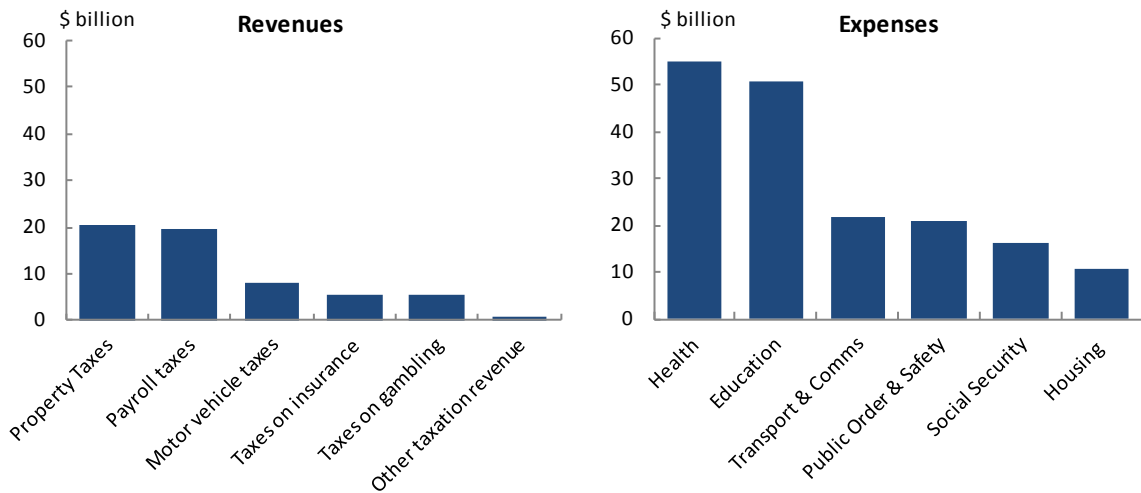
Total Commonwealth funding to the States represents around one quarter of the Commonwealth Budget and 40 per cent of State revenue.

Chart 3.3: Vertical fiscal imbalance in Australia

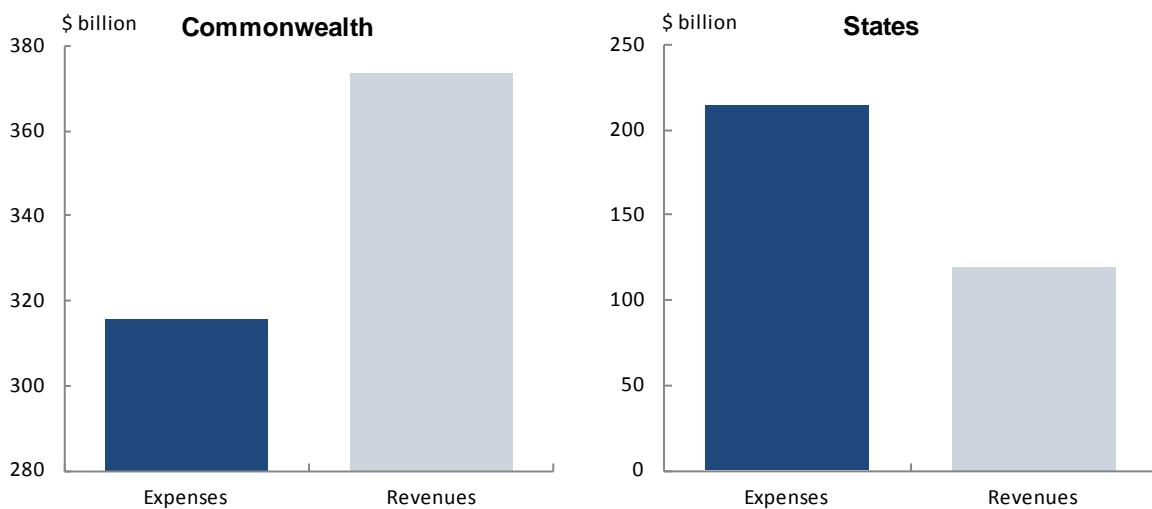
Panel A: Commonwealth major own source revenues and expenses



Panel B: States major own source revenues and expenses



Panel C: Total revenues and expenses



Source: Australian Bureau of Statistics Cat No. 5512.0 and 5506.0.

As well as having to deal with vertical fiscal imbalance, the States have different capacities to raise revenue and deliver services. A form of fiscal equalisation occurs through separate arrangements which determine how the GST revenue pool is shared between them.

The Commonwealth Grants Commission decides how the GST should be allocated under a complicated formula. It determines adjustment to the shares that would otherwise prevail if an equal per capita formula for sharing was used.

Horizontal fiscal equalisation is intended to provide budget support to the less wealthy States so they can provide services that are comparable to the larger States.

As shown in Table 3.1, the extent of horizontal fiscal equalisation currently represents around 9 per cent of the GST pool or around \$4.7 billion from a total GST collection of \$50 billion.

Table 3.1: Distribution of revenue from the GST - by State

(\$ million)	2000-01			2013-14		
	Equal per capita distribution	Grants Commission distribution	Difference	Equal per capita distribution	Grants Commission distribution	Difference
NSW	10,182	9,262	-920	16,053	15,558	-495
VIC	7,488	6,523	-965	12,479	11,320	-1,159
QLD	5,617	5,721	104	10,133	10,741	608
WA	2,977	2,930	-48	5,493	2,458	-3,036
SA	2,348	2,776	428	3,629	4,595	966
TAS	733	1,106	373	1,111	1,801	689
ACT	491	546	55	834	1,022	188
NT	308	1,280	972	517	2,756	2,239
Total	30,145	30,145	0	50,250	50,250	0
Amount redistributed:						
\$ million			1,932			4,689
per cent of pool			6%			9%

Source: 2013-14 Budget Paper No. 3 and 2000-01 Budget Paper No. 3. Does not take into account distribution of unquarantined health care grants.

3.3 The current Intergovernmental Agreement on Federal Financial Relations

In recent decades, the operation of the Federation has been characterised by a proliferation of small payments from the Commonwealth to the States, with increasing numbers of conditions imposed by the Commonwealth on how the money should be spent.

The number of Commonwealth agreements with the States now stands at more than 140, blurring the roles and responsibilities of the Commonwealth and the States and leading to duplication, overlap and high administration costs.

Under the auspices of the Council of Australian Governments, the 2008 *Intergovernmental Agreement on Federal Financial Relations*, agreed between the Prime Minister, premiers and Territory chief ministers, was designed to partially address this through an improved framework for the operation of the Federation.

The Agreement was intended to significantly simplify arrangements through a smaller number of financial transfers from the Commonwealth to the States with fewer prescriptions on how funds could be used.

It sought to foster collaborative working arrangements, with more clearly defined roles and responsibilities. It was also intended to improve the transparency with which the States reported on the outcomes of their programmes that were funded by grants from the Commonwealth. Reducing administrative and compliance costs was an associated objective.

Under the new arrangements a wide range of specific Commonwealth-State agreements were subsumed into six National Agreements across the key areas of health care; education, skills and workforce development; disability services; affordable housing; and Indigenous reforms.

The intent of the arrangement was to provide the States with greater flexibility to spend the money provided by the Commonwealth in a way that produces the best results.

In addition to the key national agreements, a number of separate agreements — National Partnership Agreements — were developed to support the delivery of specified programmes identified as having whole of nation implications.

Greater accountability for the results was supposed to be achieved through improved public reporting by the newly formed COAG Reform Council.

The new arrangements did not deliver expected results. While there was an initial decrease in the number of funding agreements with States, the number grew again as Commonwealth ministers sought to prescribe particular policy directions or categorise policies and projects as being of significant national importance.

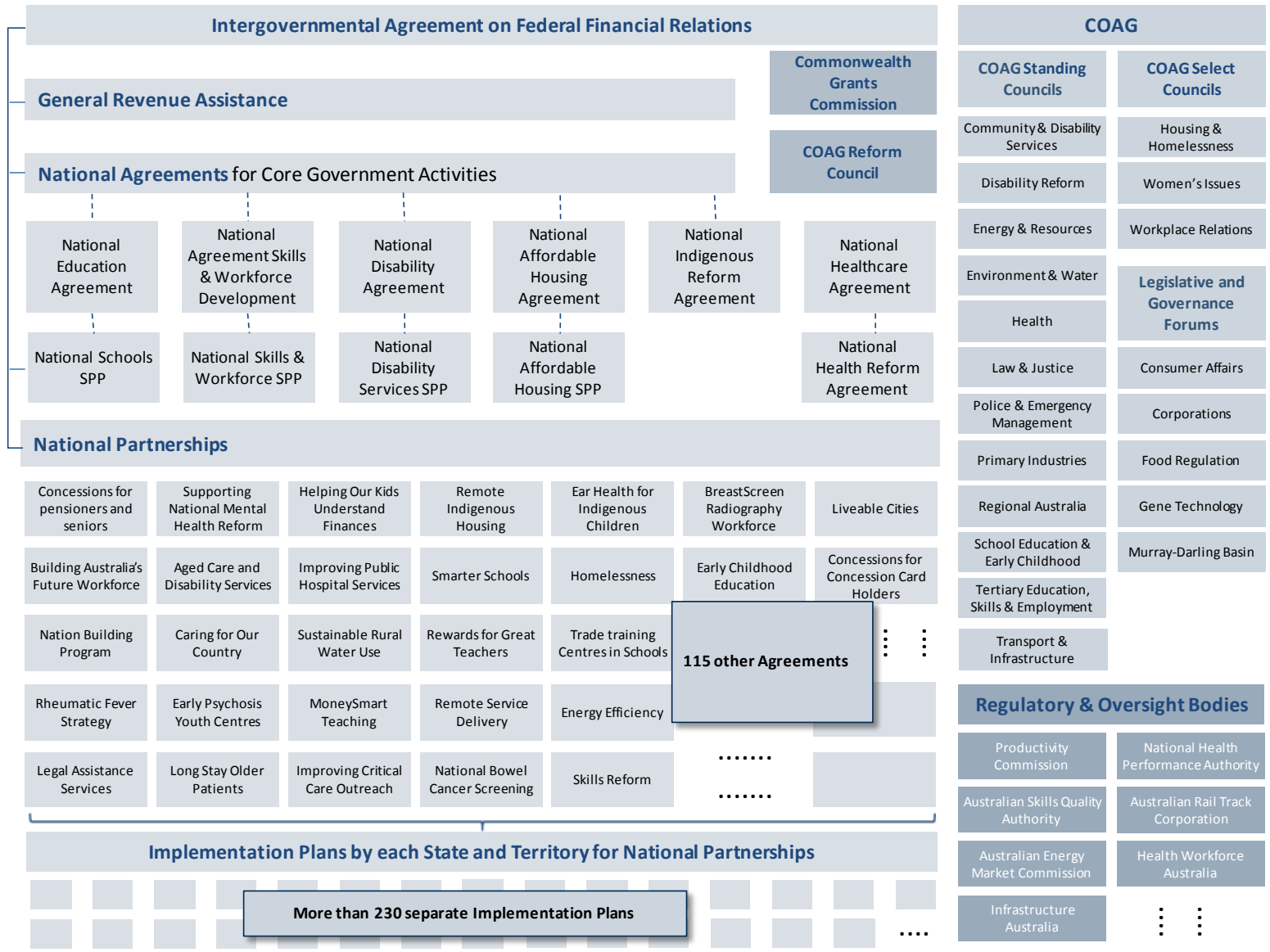
As noted by the Productivity Commission, by the end of 2010 the Intergovernmental Agreement and associated Council of Australian Governments architecture had created a catalogue of over 300 documents, including six National Agreements, 51 National Partnership Agreements and 230 Implementation Plans.

This proliferation of agreements increased administrative costs through the burden of negotiating and managing agreements, including the reporting required from the States to qualify for payments.

For example, the Victorian Government advised the Commission that the number of reports it had to provide under National Partnerships and Project Agreements doubled from 90 in 2008-09 to 180 per year in 2012-13.

Chart 3.4 summarises the structure of federal financial relations under the current Intergovernmental Agreement.

Chart 3.4: Current structure of federal financial relations



Source: Department of Treasury.

3.4 How does the Commonwealth provide and fund its services?

The Commonwealth develops policy, delivers services and enforces laws through a range of portfolios, departments, agencies and other bodies.

How a government structures its affairs reflects the priorities of the government of the day, as well as conventions and constitutional requirements.

In particular:

- Portfolios reflect broad subject areas of responsibility assigned to Commonwealth ministers under the Administrative Arrangements Order.
- Departments are the arms of the executive government responsible for advising, administering and overseeing Commonwealth Government policy. Core departmental functions typically include advising on policy, administering programmes, preparing legislation and coordinating portfolio-wide activities and budgets. Departments also play a key role in supporting the portfolio minister to undertake his or her responsibilities – for example the Department of Agriculture.
- Agencies and authorities are separate bodies within a portfolio with specific functions and structures that are of a different or specialist nature, sometimes requiring a degree of independence from government. Activities commonly include service delivery, regulation and enforcement – for example the Australian Fisheries Management Authority.
- Commonwealth companies and other bodies include bodies under the *Commonwealth Authorities and Companies Act 1997*. These bodies are not legally or financially part of the Commonwealth and hold money on their own account (for example, the Grains Research and Development Corporation in the Agriculture Portfolio, and other entities such as the Australian Broadcasting Corporation and NBN Co Limited in the Communications Portfolio).

Current structures

There are currently 16 federal government portfolios. Within these portfolios there are 194 entities, including departments, agencies, authorities and companies. In addition, there are around 700 other bodies including boards, committees and councils that the Commonwealth supports.

As illustrated below, there are seven portfolios that could be considered ‘core’ to the Commonwealth Government (to the extent there is no overlap with the States). Examples include Defence, Immigration, Foreign Affairs and Trade, and the Treasury.

There are nine portfolios of significant importance to the community, where responsibilities are largely shared with the States. Examples include Industry, Health and Education.

Within portfolios there are multiple entities that carry out specific functions. For example, the Treasury Portfolio includes 18 entities, such as the Australian Taxation Office, the Royal Australian Mint and the Australian Bureau of Statistics.

The Health Portfolio has the largest number of separate entities including the National Blood Authority, Organ and Tissue Authority and the Australian Institute of Health and Welfare.

A brief, high-level overview of the 16 Commonwealth portfolios is outlined in Section 4 of the detailed Appendix to this report.

Depending on the activity, there may be an appropriate governance reason for a separate entity rather than a government department to undertake specific functions.

With a total of 194 Commonwealth entities delivering services and providing policy advice there are significant risks of duplication and overlap, causing unnecessary complexity and a lack of accountability.

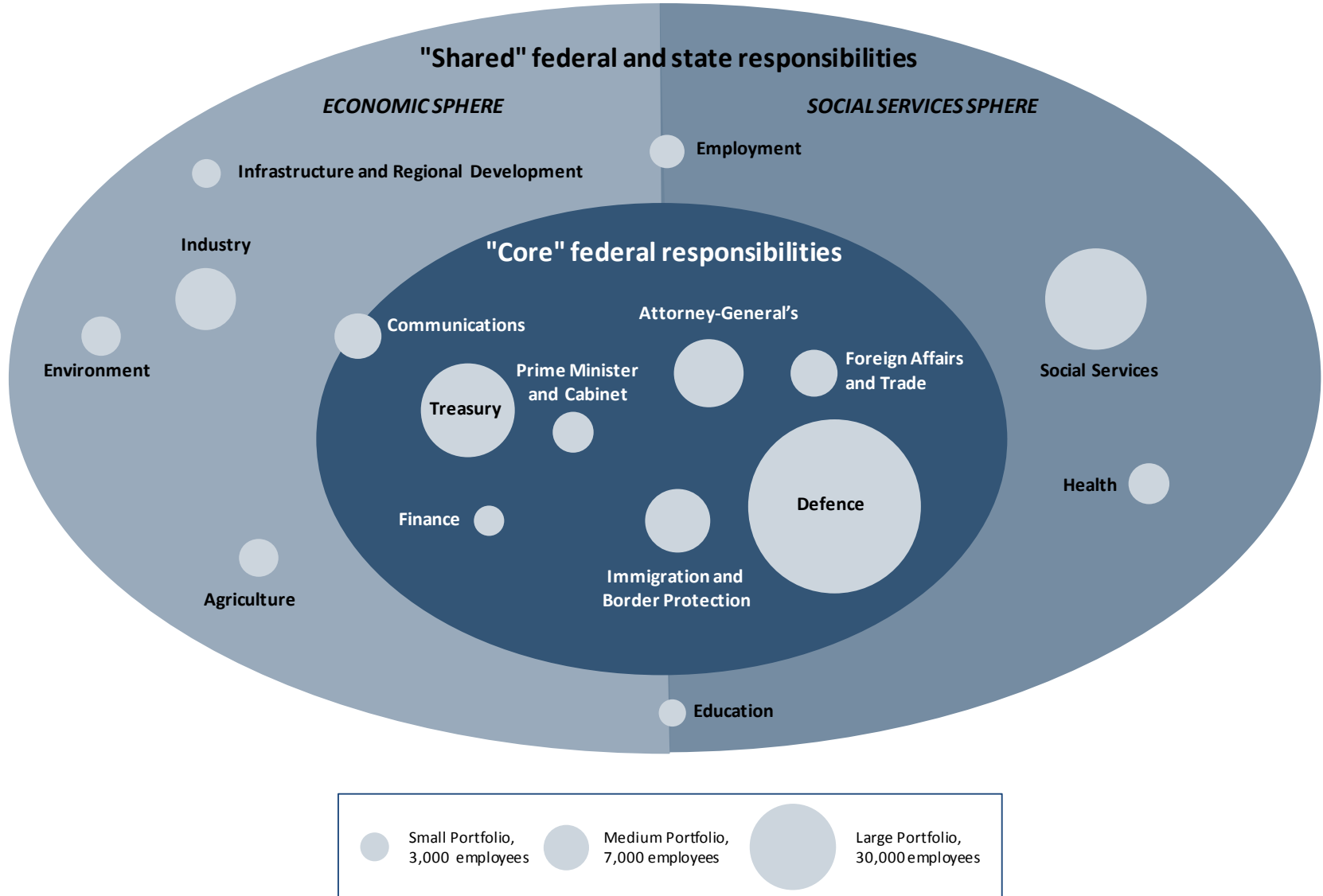
In terms of the size and structure of the Commonwealth Public Service, Australia's current arrangements and number of portfolios and entities is not significantly different to comparable countries. See Table 3.2 below. But when the other bodies are included and along with the overlap with the States real problems of waste and inefficiency emerge.

Table 3.2: Comparison of size of government between similar systems

Country	Departments of State	Special Entities	Other Agencies	Public & Crown Corporations	Total Bodies
New Zealand	29	6	85	36	156
United Kingdom	24	21	333	11	389
Canada	20	45	65	82	212
Australia	18	7	149	20	194

Source: OECD National Accounts at a Glance 2012; IMF World Economic Outlook 2013; Australian Department of Finance (2013), New Zealand State Services Commission (2013); Gov.UK (2013); Government of Canada (2013); R. Gregory The challenging quest for governmental accountability in New Zealand (2012).

Chart 3.5: Commonwealth portfolios



Source: National Commission of Audit.

Management of Commonwealth funds

The Commonwealth Government has a well established financial framework to ensure its departments, agencies and companies are held to a high standard in managing taxpayer funds.

Section 81 of the Constitution provides that all revenues or monies raised or received by the executive government of the Commonwealth shall form one revenue fund. This is the Consolidated Revenue Fund.

Section 83 provides that no money shall be drawn from the Treasury of the Commonwealth except under appropriation made by law.

Together sections 81 and 83 provide that there must be an appropriation, made by law, for the purposes of the Commonwealth, before money may be drawn from the Consolidated Revenue Fund.

This is a key element of the provisions which safeguard Parliament's control over government spending.

Government entities are resourced with appropriations from the Consolidated Revenue Fund. They are subject to overarching rules regulating their financial activities, covering governance arrangements, resource management, auditing and accountability.

Government agencies may use such funds as 'departmental expenses' or 'administered expenses'.

Departmental expenses are generally costs departments control, including employee salaries and supplier charges.

Administered expenses are administered by a department or agency (including grants, subsidies and benefit payments set by eligibility rules and conditions established by the government and Parliament). Departments have less discretion over how administered expenses are incurred.

Of total Commonwealth spending in 2013-14, some \$360 billion (or 88 per cent) comprised administered expenses with less than \$50 billion (or 12 per cent) categorised as departmental expenses.

The Australian Public Service

The *Financial Management and Accountability Act 1997* and the *Commonwealth Authorities and Companies Act 1997* regulate the financial activities of government.

The first Act sets out the financial, accountability and audit obligations of agencies and departments. It requires efficient, effective and ethical management of public resources and appropriate accounts and records of the receipt and expenditure of public money.

The second Act sets out obligations on Commonwealth statutory authorities and companies in which the Commonwealth has at least a direct controlling interest. It also specifies reporting and audit obligations for directors of authorities; standards of conduct for officers of authorities; and the requirement that wholly-owned Commonwealth companies keep ministers and Parliament informed of their activities.

The *Public Governance, Performance and Accountability Act 2013* is scheduled to replace these Acts from 1 July 2014. It is intended to modernise and simplify the current arrangements, based on four key principles:

- government should operate as a coherent whole;
- uniform duties should apply to all resources handled by Commonwealth entities;
- public sector performance is more than financial; and
- engaging with risk is a necessary step in improving performance.

This Act is intended to reinforce an apolitical public service that is efficient and effective. It provides a legal framework for the employment and management of Australian Public Service employees and defines the powers and responsibilities of agency heads, the Public Service Commissioner and the Merit Protection Commission.

The Australian Public Service currently employs around 165,000 people under the *Public Service Act 1999* plus an additional 150,000 or so employed separately, including military personnel and employees in Commonwealth statutory authorities and companies.

4 – The state of the Commonwealth’s finances

The Commission has been asked to assess the financial position of the Commonwealth including the state of its balance sheet.

The Commission has also been asked to review and report on the long-term sustainability of the Budget position identifying key policy areas where trends in expenses and revenue pose risks to the structural integrity of the Budget. This chapter deals with these issues.

4.1 Overview of the Commonwealth’s finances

For the year ended 30 June 2013, the Commonwealth Government recorded an underlying cash deficit of \$18.8 billion, equivalent to 1.2 per cent of GDP. In the current 2013-14 financial year the underlying cash balance is projected to record a deficit of \$47.0 billion or 3.0 per cent of GDP. This reflects:

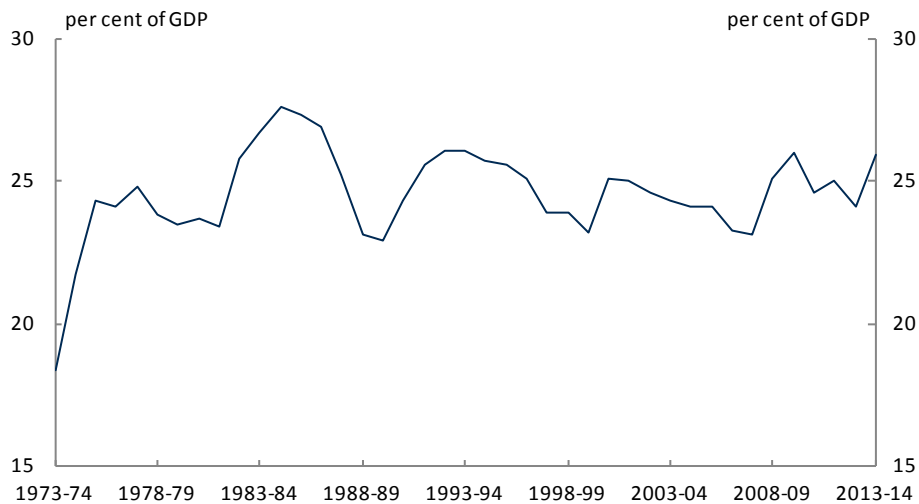
- projected Commonwealth payments of \$409 billion, amounting to 25.9 per cent of GDP; and
- projected Commonwealth taxation receipts of \$343 billion or 21.8 per cent of GDP. After taking account of some \$21 billion of expected non-tax receipts, total Commonwealth revenue is projected to be 23.1 per cent of GDP.

As shown in Chart 4.1 below, Commonwealth Government spending as a share of GDP remains close to the recent peak of 26 per cent recorded in 2009-10. Spending as a share of GDP is well above the average of the past 20 years of 24.6 per cent of GDP.

Total government payments have grown significantly over the past 10 years at an average annual rate of 3.6 per cent in real terms. This reflects both growth in a number of demand driven legislated payments and a wide range of policy decisions.

These policies include the 2009 adjustment to benchmark the Age Pension against a higher proportion of Male Total Average Weekly Earnings and the uncapping of Commonwealth supported university places.

Chart 4.1: Commonwealth spending as a share of GDP

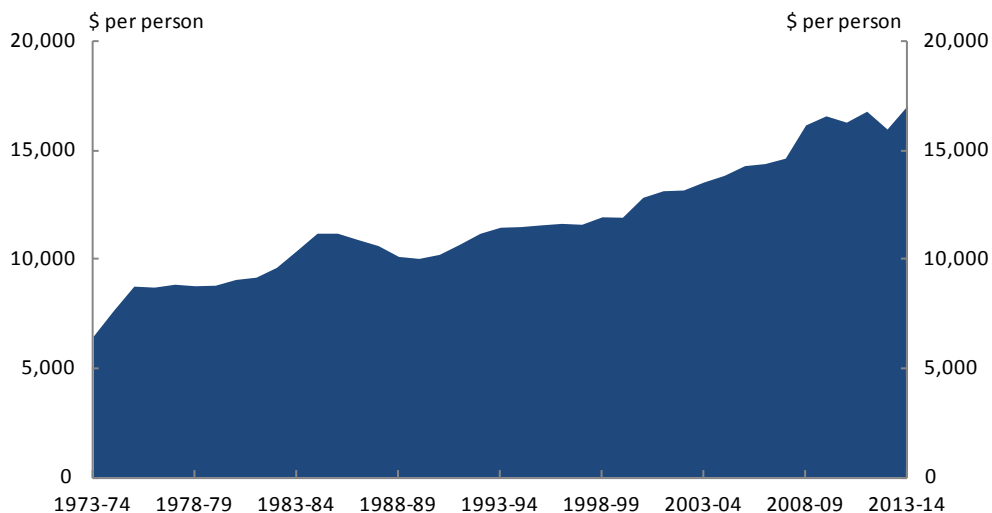


Source: Mid-Year Economic and Fiscal Outlook 2013-14.

The size and scope of government has increased significantly over time. Over the last 40 years, adjusted for inflation, government spending has almost tripled, from around \$6,000 per person per year to over \$15,000 per person per year today.

The growth in real payments per person reflects the greater role that government plays in the lives of Australians and the economy. As well as government policy decisions and higher expectations from the community, higher public spending reflects the ageing of Australia's population and the fact that there are, proportionally, far more older people now (who tend to receive more government services).

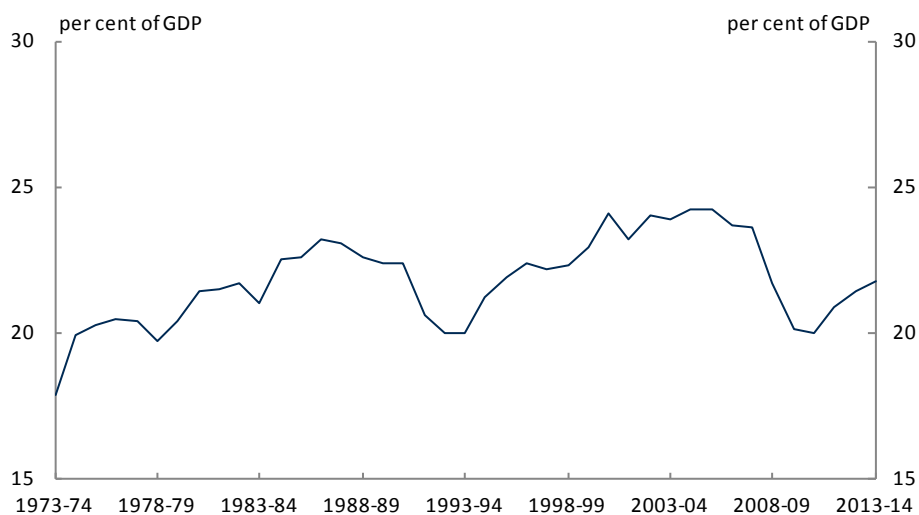
Chart 4.2: Commonwealth real spending per person (2012-13 dollars)



Source: Mid-Year Economic and Fiscal Outlook 2013-14 and National Commission of Audit.

As shown in Chart 4.3, Commonwealth tax receipts as a share of GDP have been subdued in recent years. At a current level of 21.8 per cent of GDP, tax collections are below the 20 year average of 22.4 per cent of GDP and well below the 23.6 per cent of GDP recorded in 2007-08.

Chart 4.3: Commonwealth taxes as a share of GDP



Source: Mid-Year Economic and Fiscal Outlook 2013-14.

The tax-to-GDP ratio provides a measure of how much tax is collected per dollar of economic activity.

As the Commonwealth is highly reliant on personal and corporate income tax, tax revenue is closely linked to the nominal economy. Accordingly, the biggest risk to revenue is an economic downturn or a sharper than expected decline in the terms of trade.

Several factors have weighed down corporate tax receipts in recent years, including the protracted recovery from the global financial crisis and the changing composition of the company tax base with a greater contribution from the mining sector.

Ten years ago the mining sector contributed less than 20 per cent to the company tax income base, whereas it now contributes around 37 per cent. This is important for company tax collections because the mining sector utilises several deductions more heavily than other sectors, particularly capital deductions and deductions for State royalty payments.

Australia's high reliance on corporate tax also means the risk of multinational base erosion and profit shifting is heightened relative to other countries. Corporate tax accounted for nearly a quarter of Commonwealth tax receipts in 2012-13.

This increase in reliance on corporate taxes (and capital gains tax), matched by a structural decline in the comparatively stable indirect taxes and the temporary decrease in individuals' taxes, has led to increasingly volatile tax collections.

The current mix of tax collections, along with our exposure to movements in the terms of trade, impose significant risks to the medium-term revenue outlook and increases uncertainty around revenue forecasts.

The Government has committed to consult the community to produce a comprehensive tax White Paper with all aspects of the tax system 'on the table'.

The tax reform White Paper, alongside the Government's proposed Federation White Paper, provides a significant opportunity to improve government and strengthen the economy. Maximising these benefits will involve enlisting State and Territory governments in the tax reform process.

4.2 The state of the balance sheet

While the Budget position provides an important measure of the government's financial position, the Commonwealth balance sheet supplies a more complete picture of the underlying strength of the Commonwealth's position.

As at 30 June 2013, the Commonwealth Government's general government balance sheet was made up of financial assets totalling \$251 billion, including the Future Fund, equity investments in public sector entities, higher education loans and taxes receivable.

The Future Fund was established in 2006 to help government meet unfunded superannuation benefits for public servants. The value of its assets is currently \$96.6 billion.

The value of the Commonwealth Government's equity investments in public corporations is \$25.1 billion. This includes its stake in major government-owned entities such as NBN Co, Medibank Private and Australia Post.

The amount owed to the Commonwealth Government under the Higher Education Loan Programme was \$21.6 billion. Recent policy decisions to uncap funding for university places and ongoing demand for loans for postgraduate and vocational education and training courses are expected to drive continued strong growth in the next five to 10 years.

As at 30 June 2013, the Commonwealth Government's balance sheet included non-financial assets totalling \$110.1 billion. Over 60 per cent of these are held by the Department of Defence and related agencies, largely in the form of plant, equipment, infrastructure and buildings.

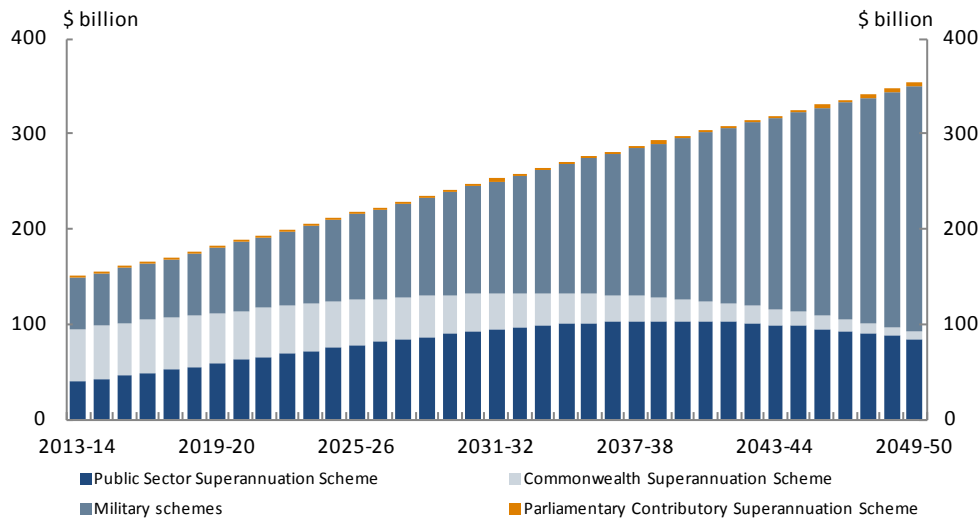
The government also has \$10.5 billion in heritage and cultural assets. These include paintings and artefacts in the nation's cultural institutions such as the National Gallery, National Library and National Archives.

The balance sheet also records Commonwealth liabilities totalling \$563.5 billion as at 30 June 2013, including \$285.7 billion of debt in the form of Commonwealth Government

Securities, almost all of which is in the form of Treasury bonds and notes outstanding. In addition there is \$193.3 billion in public sector superannuation liabilities.

As shown in Chart 4.4, a significant pressure on the balance sheet is unfunded superannuation liabilities for public servants and military personnel.

Chart 4.4: Unfunded Commonwealth Government superannuation liability projections



Source: Department of Finance.

The Commonwealth’s defined benefit superannuation schemes — which broadly pay a set benefit as a proportion of salary on retirement — are not funded over time through regular contributions from government. They represent a major pressure on future budgets.

The Commonwealth’s unfunded superannuation liability for defined benefit schemes is currently estimated at some \$150 billion rising to over \$350 billion by 2050.

The Commonwealth’s main defined benefit schemes included the Commonwealth Superannuation Scheme, the Parliamentary Contributory Superannuation Scheme and the Public Sector Superannuation Scheme. These schemes closed to new members in 1990, 2004 and 2005 respectively.

The Military Superannuation and Benefits Scheme remains open to new members and is projected to be the main driver of the Commonwealth’s superannuation liability growth from 2030.

Table 4.1: Major balance sheet items

Account	2011-12 (\$ billion)	2012-13 (\$ billion)
Financial Assets		
Higher education loans	19.4	21.6
Taxes receivable (net)	18.7	20.5
Accrued taxation revenue	10.7	10.9
Deposits (mostly held by the Reserve Bank of Australia)	28.7	32.5
Collective investment vehicles (Future Fund)	24.8	29.5
Share investments (Future Fund)	28.6	33.7
Investments in public corporations	21.1	25.1
Other interest-bearing securities	31.5	31.4
Other	37.8	45.7
<i>Total</i>	<i>221.3</i>	<i>250.8</i>
Non-financial Assets		
Buildings (excluding the land component)	23.3	23.5
Heritage and cultural assets	10.4	10.5
Specialist military equipment	40.3	40.3
Other plant and equipment	12.5	12.6
Other	24.5	23.1
<i>Total</i>	<i>111.1</i>	<i>110.1</i>
Interest-bearing liabilities		
Government securities	269.8	285.7
Other	10.3	14.9
<i>Total</i>	<i>280.1</i>	<i>300.6</i>
Provisions and payables		
Superannuation liability	235.4	193.3
Other employee liabilities	14.5	14.8
Grant provisions	11.8	12.9
Provision for outstanding benefits and claims	10.6	11.4
Other	27.2	30.5
<i>Total</i>	<i>299.5</i>	<i>262.9</i>
Net worth (total assets minus total liabilities)	-247.2	-202.7
Net financial worth (financial assets minus total liabilities)	-358.3	-312.7

Source: Department of Finance.

Note: Superannuation liability difference between financial years largely reflects the different discount rate applicable in the relevant financial year

The Commonwealth Government has also taken on risks from the private sector in the form of guarantees and concessional loans. These include guaranteeing approximately \$13.1 billion of aged care accommodation bonds in case of provider default, \$3.3 billion of liabilities of the Export Finance and Insurance Corporation and nearly \$700 billion of deposits as part of the Financial Claims Scheme.

The Financial Claims Scheme provides depositors of banks and other authorised deposit taking institutions such as building societies with timely access to their funds in the event of a financial institution failure. Similarly, the Commonwealth guaranteed large deposits and wholesale funding for banks during the global financial crisis, with \$40.7 billion of funds still under guarantee.

The balance sheet also currently reflects the Commonwealth's financing of the \$10 billion Clean Energy Finance Corporation, including concessional loans and guarantees to renewable energy companies. The Government has proposed to abolish the Clean Energy Finance Corporation.

These guarantees are reported as contingent liabilities in the Budget papers. They are relevant to any assessment of the Commonwealth's financial position because should they be called they would have a material impact on the fiscal position. The need to better account for government loans and guarantees is discussed in Section 5.2.

Other items of an 'asset' or 'liability' nature not recorded on the balance sheet include intangibles such as intellectual property, including copyrights, databases and digital images and government rights (including the right to levy taxes or issue permits).

The Commonwealth balance sheet has deteriorated significantly in recent years. The broadest measure of Australia's balance sheet is net worth, equivalent to total assets minus total liabilities. The Commonwealth's net worth currently stands at minus \$202.7 billion.

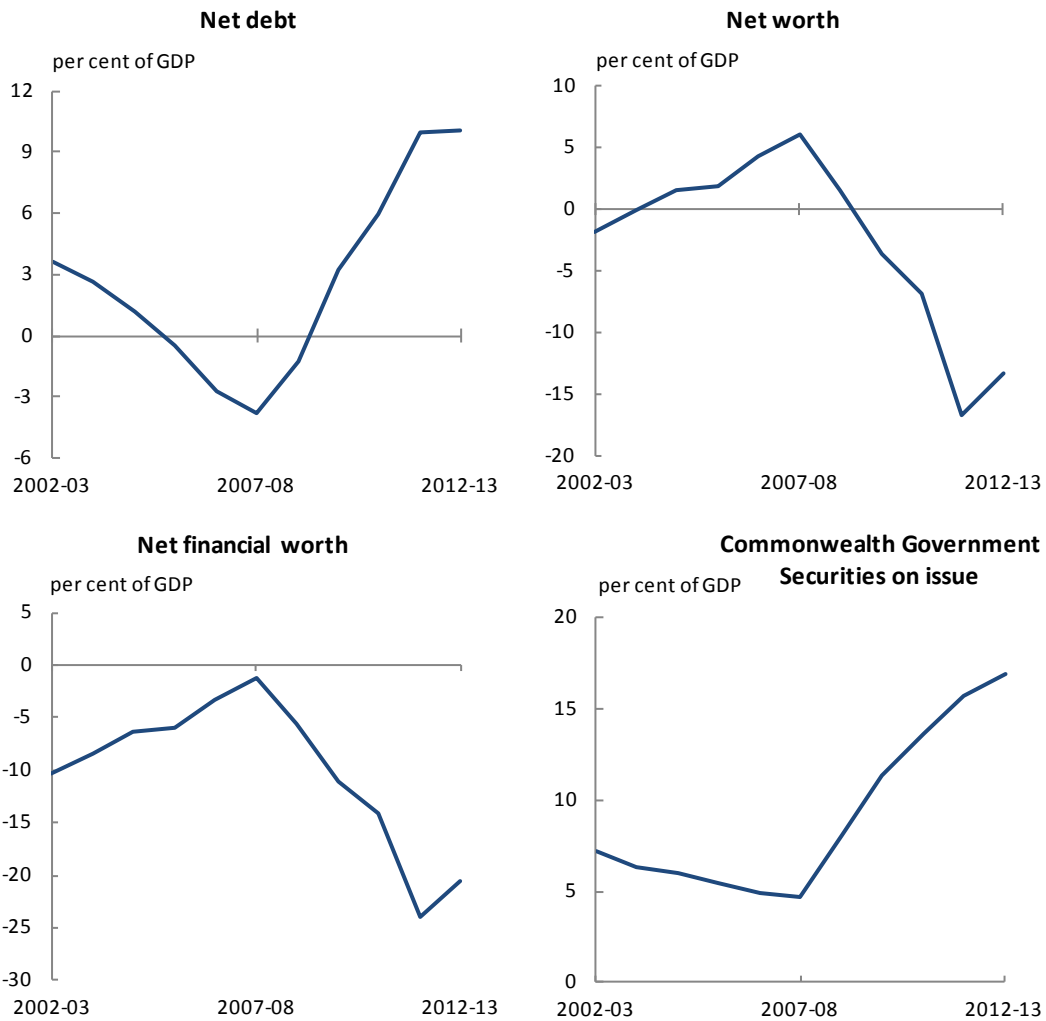
Net financial worth, which is equivalent to financial assets minus liabilities, is usually considered a better measure of fiscal sustainability as it captures government's ability to withstand adverse economic shocks by drawing on its stock of liquid assets. As at 30 June 2013 Australia's net financial worth stood at minus \$312.7 billion.

Net debt (which comprises interest bearing liabilities, including bonds on issue, less any liquid financial assets) is a less broad measure but nonetheless the most common metric used for international comparisons. As at 30 June 2013, Commonwealth Government general government sector net debt was \$153 billion or just over 10 per cent of GDP.

As outlined in Chart 4.5 below, each of these three balance sheet metrics has deteriorated since 2007-08 due to the increase in debt arising from bond issues needed to fund government budget deficits as well as the growth in public sector superannuation liabilities.

These increases in liabilities have been partially offset by increases in a number of assets including those held by the Future Fund and an increase in higher education loans.

Chart 4.5: Balance sheet metrics



Source: Mid-Year Economic and Fiscal Outlook 2013-14.

Management of the items on the government’s balance sheet is decentralised to the responsible agencies, with limited oversight by the Department of Finance. The Auditor-General has a broad audit and assurance role.

Over time the overall quality of government asset and liability management has improved in many areas. For example, the creation of the Future Fund to mitigate the risk associated with the unfunded superannuation liability, and greater use by departments of asset management plans.

Nevertheless, the scale of government asset and liabilities is such that a high-level review of asset and liability management (including items not recorded on the balance sheet) would be timely.

4.3 Fiscal projections

Medium-term outlook to 2023-24

Revenue and spending is inherently difficult to project accurately – both in the near term and over the longer term.

Nonetheless projections can serve a useful purpose, increasing transparency and assisting prudent policy decisions in matters which have material longer term impacts.

Notwithstanding the inherent uncertainties, it is possible to obtain an approximation of likely trends in payment growth on the basis of what we know about likely population growth, demographic changes, indexation factors and likely take up rates for certain programmes.

Projecting revenue is more difficult and at best an approximation can be made based on historical relationships between tax collections and with assumed rates of nominal GDP growth.

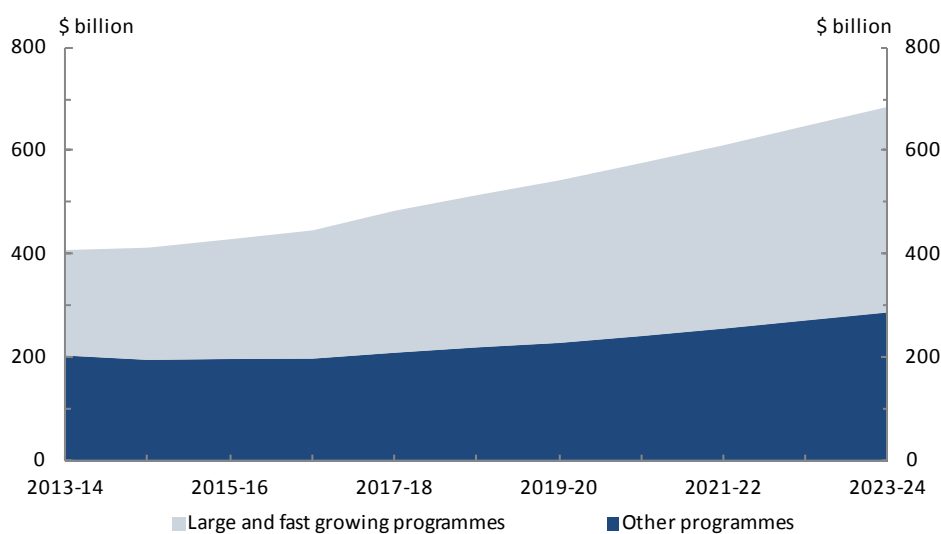
Growth in spending

Growth in payments (in real terms) is expected to be 0.6 per cent per year from 2013-14 to 2016-17 and payments as a share of GDP are projected to fall from 25.9 per cent to 25 per cent over this period.

However, the Commission expects real growth in payments to increase materially from 2016-17 to 2023-24 to an average rate of 3.7 per cent per year. On this trajectory spending would grow as a share of GDP from 25 per cent to 26.5 per cent.

The strong growth in payments beyond 2016-17 reflects the impact of recent initiatives in areas such as the National Disability Insurance Scheme and schools funding, as well as continued strong growth in health spending and underlying growth in other programmes such as Australia's foreign aid programme.

Chart 4.6: Projected Commonwealth spending



Source: National Commission of Audit.

Strong growth in spending is in part driven by the ageing population. The *Intergenerational Report 2010* highlighted the impact demographic change has on the Commonwealth Budget. An ageing population places pressure on government expenditure while the portion of working-age taxpayers is falling.

Over the next 10 years, combined growth in spending on social security and welfare, health and education is projected to contribute the most to growth in total expenses.

For the period 2013-14 to 2023-24 the Commission has focused on the 15 largest and fastest growing programmes. They are, in almost all cases, projected to grow faster than average growth in total government expenditure. Most are also expected to grow considerably faster than GDP.

These 15 policy areas will account for around 70 per cent of the total growth in payments over the next 10 years. (As outlined in Table 4.2 below.)

In addition to the growth in payments included in this table, the Government has made commitments on increasing Defence spending (to reach 2 per cent of GDP within a decade) and on the Private Health Insurance Rebate (to remove means testing when appropriate to do so). As no firm decision has been taken on these matters they were not included in the Mid-Year Economic and Fiscal Outlook Update and are not considered in the Commission's assessment.

If these commitments were implemented, the Commission estimates that they would add an additional \$17 billion to total Commonwealth government spending in the medium term.

Table 4.2: Large and fast growing programmes

	\$ billion	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	Average annual growth (per cent)
Age Pension		39.5	42.3	45.2	48.7	51.7	54.6	57.8	61.1	64.6	68.3	72.3	6.2
Defence		25.3	27.0	28.1	28.6	34.1	35.8	36.7	37.6	38.6	40.7	41.4	5.1
Family Tax Benefit		19.4	19.7	19.5	19.8	20.1	20.5	20.9	21.3	21.7	22.1	22.6	1.5
Medicare Benefits Schedule		19.0	20.4	21.7	23.1	24.8	26.6	28.6	30.7	32.9	35.2	37.7	7.1
Disability Support Pension		15.8	16.4	17.0	17.8	18.6	19.6	20.6	21.6	22.7	23.9	25.2	4.7
Hospitals		14.0	15.4	17.0	18.8	20.8	23.1	25.6	28.3	31.2	34.4	37.8	10.4
Schools		12.9	14.1	15.4	16.8	18.7	20.6	23.5	26.2	27.7	29.4	31.0	9.2
Aged Care and Population Ageing		12.8	13.8	14.8	16.0	17.3	18.6	20.0	21.9	23.7	25.0	26.4	7.5
Job Seeker Income Support		10.1	10.6	11.2	11.7	12.4	12.7	12.9	13.2	13.5	13.7	14.0	3.3
Pharmaceutical Benefits Scheme		9.3	9.3	9.6	10.2	10.8	11.5	12.3	13.0	13.8	14.7	15.6	5.4
Higher Education		7.1	7.4	7.8	8.2	8.5	9.1	9.7	10.3	11.0	11.8	12.6	5.8
Child Care and Paid Parental Leave		7.0	7.8	10.7	12.8	13.8	14.8	15.8	17.0	18.2	19.5	20.9	11.5
Income Support for Carers		6.8	7.5	8.1	8.9	9.8	10.8	11.9	13.1	14.3	15.7	17.1	9.6
Official Development Assistance		5.0	5.2	5.3	5.4	9.0	9.5	10.0	10.5	11.1	11.8	12.5	9.6
National Disability Insurance Scheme		0.3	0.4	0.5	1.8	4.5	7.0	8.6	9.4	10.0	10.7	11.3	46.2
Total listed programmes		204	217	232	248	275	295	315	335	355	377	398	6.9
Total Commonwealth payments		409	414	430	447	485	515	544	578	612	649	686	5.3
Nominal GDP		1,577	1,631	1,708	1,788	1,874	1,970	2,072	2,191	2,316	2,448	2,588	5.1

Source: National Commission of Audit.

Note: Programme projections are on an accrual basis, whilst payments are on a cash basis.

High level overview of major programmes

Of the 15 programmes the Commission has focussed on, **Age Pension** is the largest by a fair margin. Currently close to \$40 billion, the Age Pension is forecast to rise by 6.2 per cent per year from 2013-14 to 2023-24, when spending is projected to be over \$72 billion.

Of the projected \$32 billion increase in the cost of funding the Age Pension, around 40 per cent is driven by current arrangements to index the payment, with most of the remainder due to increasing numbers of recipients. This is an important fact.

Three large programmes in health make up around \$40 billion in Commonwealth spending.

Spending on **hospitals** (currently \$14 billion) is expected to rise to around \$38 billion by 2023-24. The Commonwealth contributes to the funding of public hospitals in the States through Australian Health Care agreements. With annual growth of 10.4 per cent between 2013-14 and 2023-24, spending on hospitals is one of the fastest growing and largest areas of government spending.

The **Medicare Benefits Schedule** currently costs around \$19 billion and is expected to grow by 7.1 per cent per year to 2023-24. The increase in expenditure largely reflects population growth and increasing use of medical services, particularly with an ageing population.

Spending on the **Pharmaceutical Benefits Scheme** is projected to grow by 5.4 per cent per year from 2013-14 to 2023-24. At present, nearly 80 per cent of the Scheme's expenditure is attributable to concessional recipients.

The **National Disability Insurance Scheme** commenced in 2013 and is expected to grow rapidly. From a very small starting point of less than \$0.5 billion for the next three years, average annual growth is projected to be over 45 per cent, from 2013-14 to 2023-24. This means that by 2023-24, NDIS spending by the Commonwealth will be around \$11 billion.

Payments to Carers are projected to increase by 9.6 per cent per year between 2013-14 and 2023-24. Rapidly rising beneficiary numbers are one of the main drivers, with annual increases in excess of 10 per cent for recipients of some payments.

Aged care is growing strongly and is forecast to double from its current level of around \$13 billion to \$26 billion in 2023-24. The increasing number of older Australians accessing aged care services is the main driver of this growth. Residential care is the largest component of aged care spending.

In 2013-14, nearly \$16 billion is expected to be spent on the 820,000 recipients of the **Disability Support Pension**. Over the next 10 years spending on the Disability Support Pension is projected to increase by 4.7 per cent per year. Population ageing drives part of the growth but a significant portion is due to indexation. The Disability Support Pension is indexed in the same manner as the Age Pension.

Growth in **child care** fee assistance and **Paid Parental Leave** is expected to be around 11.5 per cent per year between 2013-14 and 2023-24. This reflects increased usage of formal care, for which the Commonwealth provides two major subsidies and the increased generosity of the proposed changes to the Paid Parental Leave scheme.

Family Tax Benefit is growing less strongly than other areas, but is still a substantial programme. At around \$19 billion, it makes up close to 5 per cent of all Commonwealth Government spending, and is projected to be over \$22 billion in 2023-24.

Commonwealth spending on **job seekers** is currently over \$10 billion. Growth in expenditure in this area is not projected to be large as it is dependent on the unemployment rate, which, consistent with the medium-term projection methodology is assumed to be around 6 per cent.

Commonwealth spending on education is around \$20 billion, with around \$13 billion on schools and the remainder on higher education.

Schools funding is expected to grow by 9.2 per cent per year to 2023-24. This growth largely reflects indexation and per student funding goals under the Better Schools Plan.

Growth in **higher education funding** (5.8 per cent per year between 2013-14 and 2023-24) partly reflects the effect of uncapping the number of bachelor degree places in Australian universities.

In 2013-14 around \$25 billion will be spent on **Defence**. This figure which excludes capital is forecast to increase to above \$40 billion by 2023-24. The Government's aspiration is to raise defence spending to 2 per cent of GDP. Defence spending is facing ongoing cost pressures, reflecting the increasing cost and complexity of military equipment (often associated with increased capability) and personnel.

Australia's **foreign aid** programme (Official Development Assistance) is forecast to grow on average by 9.6 per cent per year between 2013-14 and 2023-24. The vast majority of this growth is attributable to the previous government's commitment to Australia's foreign aid programme reaching 0.5 per cent of Gross National Income.

It is important to note that while the Commission has focussed on the next 10 years the growth trend in the above major programmes is expected to continue unabated beyond 2023-24.

Fiscal scenarios

In order to guide its deliberations, the Commission has analysed the Commonwealth's medium-term fiscal outlook.

For the purposes of simplicity, the Commission has identified two scenarios: a 'Business as Usual' Scenario and a 'Reform' scenario.

Although they provide high level guidance for the Commission's work the scenarios do not provide detailed projections.

They involve assessments and judgements about future growth in receipts and payments at the Commonwealth level and are based on assumptions around economic growth and inflation that are reasonable and sensible.

Over the medium term, nominal GDP is projected to grow by around 5 per cent per year, with inflation growing by around 2.5 per cent per year (these and associated assumptions are outlined in further detail in Annex B).

Inevitably, the outlook is uncertain and the assumptions used may turn out to be overly pessimistic or unduly optimistic. However, we can only plan on the basis of what we know and can reasonably expect and the scenarios assist in this task.

Data on Commonwealth receipts and payments used has been sourced from the Mid-Year Economic and Fiscal Outlook update released in December 2013. This data is augmented with assumptions made by the Commission.

On the revenue side, it is assumed that tax receipts will rise in line with a strengthening economy, with the tax to GDP ratio recovering to normal levels. Once tax receipts reach 24 per cent of GDP — which is around the average level of tax receipts over the period from 2000 to the lead up to the global financial crisis — they are assumed to remain at that level.

This reflects a critical assumption that increased tax collections arising from bracket creep (as wages growth pushes taxpayers towards higher tax brackets) are partially returned by the government in the form of periodic income tax cuts. This is the established practice of Commonwealth governments over many decades.

If adjustments are not made for bracket creep, the Commission estimates that a person earning the average wage and currently facing a marginal tax rate of 32.5 per cent will be taxed at a 37 per cent marginal tax rate by 2023-24. The marginal tax rate for a person on the minimum wage would rise from 19 per cent now to 32.5 per cent well before 2023-24.

Both the 'Business as Usual' and 'Reform' scenarios assume tax receipts remain below 24 per cent of GDP. When non-taxation receipts, such as dividends and other income are included both scenarios assume total Commonwealth receipts will reach 25 per cent of GDP and remain at around that level.

The 'Business as Usual' Scenario

The Commission's 'Business as Usual' Scenario assumes that Commonwealth spending follows the same path as outlined in the Mid-Year Economic and Fiscal Outlook. The pace of spending is expected to slow through the next three years before picking up considerably in 2017-18.

On the Commission's projections, and as outlined in the previous section, spending growth will remain strong throughout the period to 2023-24.

Spending as a share of GDP is projected to reach 26.5 per cent of GDP at that time.

With total Commonwealth receipts at around 25 per cent of GDP this 'Business as Usual' scenario would produce a series of budget deficits over the coming decade. The deficit would be greater than 1 per cent of GDP each year throughout the period and beyond.

As a result of the continuing run of budget deficits, the level of the Commonwealth's net debt would increase to around 17 per cent of GDP by 2023-24 (or \$440 billion).

The table below outlines the underlying cash balance and real growth in payments under this scenario.

Table 4.3: Fiscal aggregates for the 'Business as Usual' Scenario

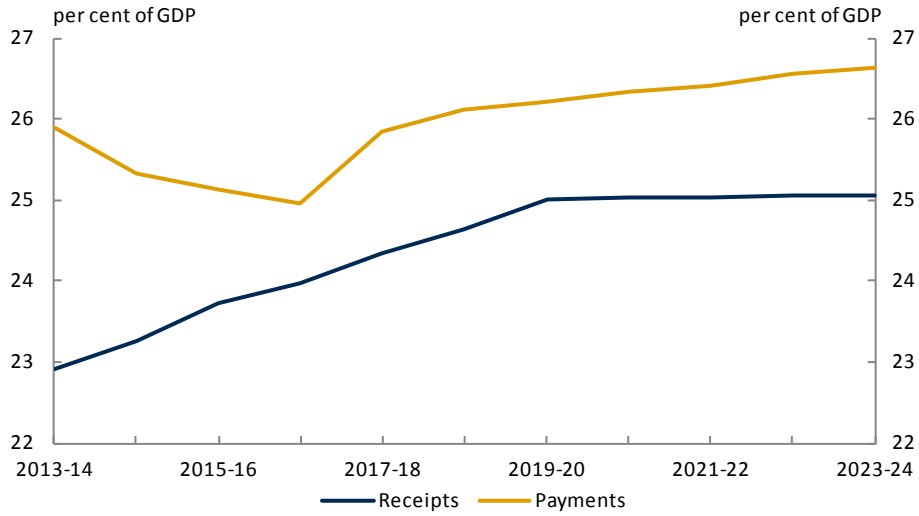
	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23	23-24
Underlying cash balance (per cent of GDP)	-3.0	-2.1	-1.4	-1.0	-1.5	-1.5	-1.2	-1.3	-1.4	-1.5	-1.6
Real growth in spending (per cent)	8.6	-0.9	1.4	1.4	5.9	3.6	3.0	3.6	3.5	3.7	3.4

Source: National Commission of Audit.

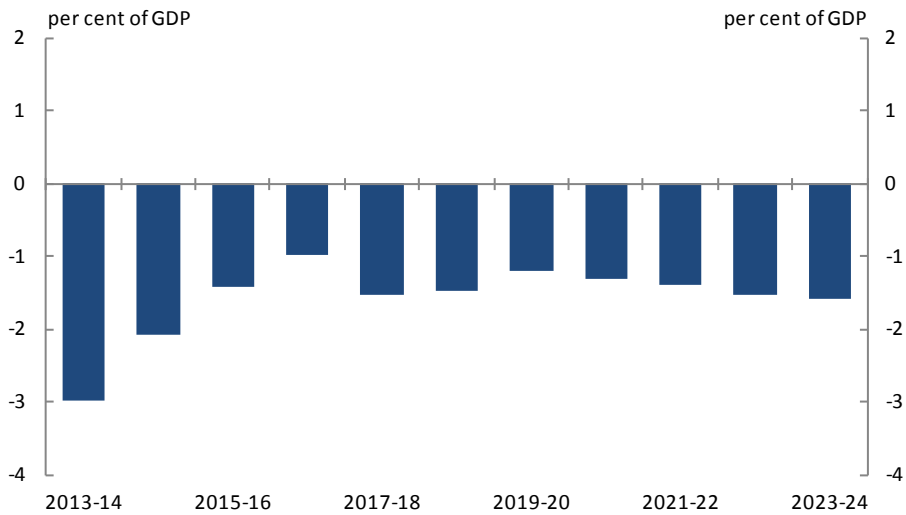
This is clearly unsustainable as we would be living beyond our means and incurring an ongoing annual interest bill on Government debt in excess of \$30 billion.

Chart 4.7: 'Business as Usual' Scenario

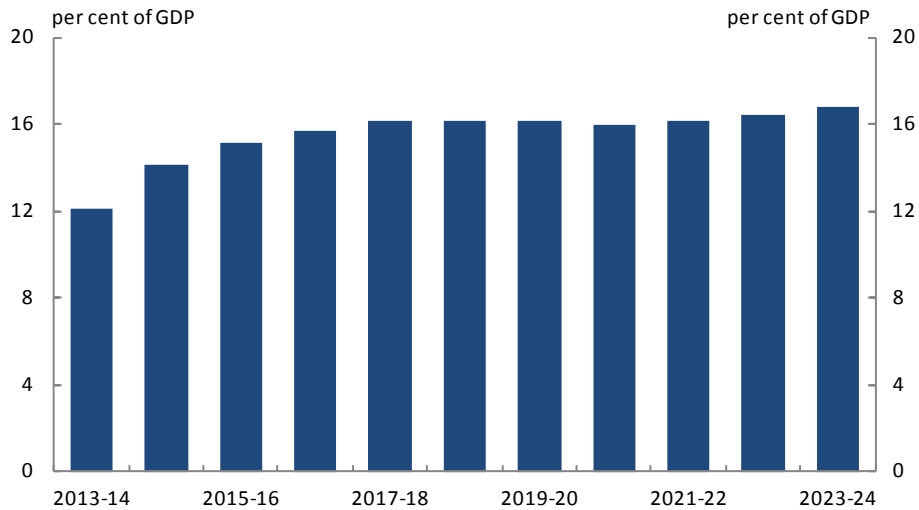
Panel A: Receipts and payments



Panel B: Underlying cash balance



Panel C: Net debt



Source: National Commission of Audit.

The 'Reform' scenario

The Commission's 'Reform' Scenario assumes a more moderate pace of spending growth over the medium term. In particular, it assumes greater expenditure restraint starts in 2014-15 and is maintained through to 2023-24.

Under this scenario payments would decline from their current level of around 26 per cent of GDP to around 24 per cent of GDP by 2023-24.

Coupled with the revenue assumption that tax receipts do not exceed 24 per cent of GDP, under the 'Reform' scenario, the Budget returns to surplus in 2019-20 with the surplus growing to 1 per cent of GDP by 2023-24.

Under this scenario Commonwealth net debt peaks at 15.1 per cent in 2016-17 and then declines to just over 5 per cent of GDP.

The table below outlines the underlying cash balance and real growth in payments under the 'Reform' scenario.

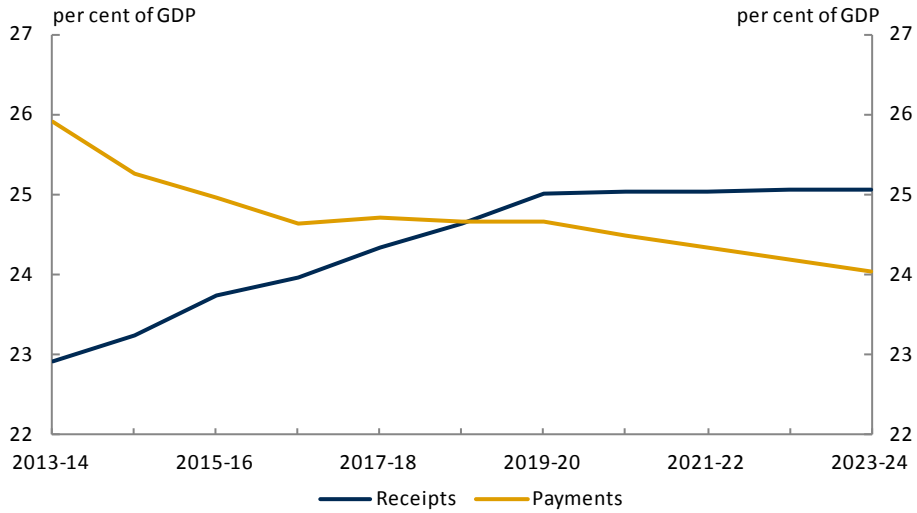
Table 4.4: Fiscal aggregates for the 'Reform' scenario

	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23	23-24
Underlying cash balance (per cent of GDP)	-3.0	-2.0	-1.2	-0.7	-0.4	0.0	0.4	0.5	0.7	0.9	1.0
Real growth in spending (per cent)	8.6	-1.1	0.9	0.8	2.5	2.5	2.5	2.5	2.5	2.5	2.5

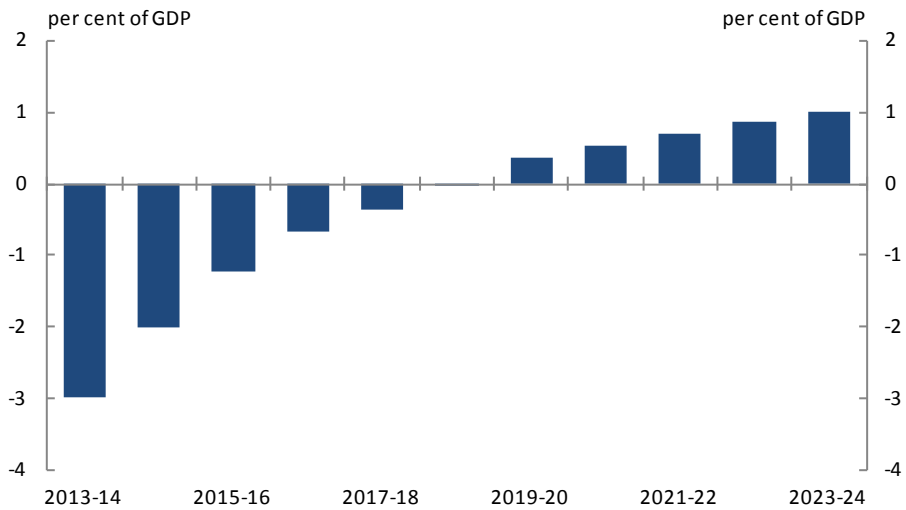
Source: National Commission of Audit.

Chart 4.8: 'Reform' scenario

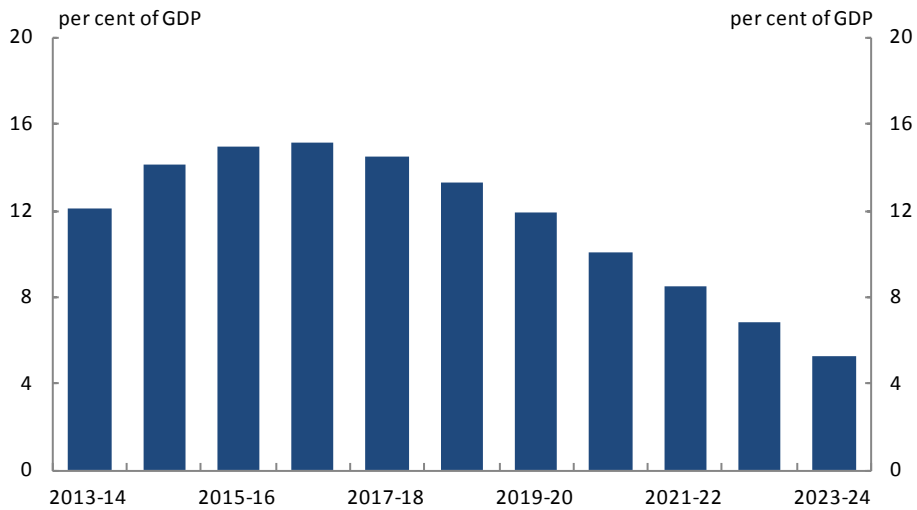
Panel A: Receipts and payments



Panel B: Underlying cash balance



Panel C: Net debt



Source: National Commission of Audit.

4.4 Restoring the nation's finances

To return Commonwealth spending and the nation's finances to a sustainable position will require a commitment from Governments to budget discipline and an acceptance by the community of the consequences.

The nation needs a credible medium-term fiscal strategy that provides certainty over the role of government and fiscal policy in the economy. This entails signing up to a set of fiscal rules that set boundaries around the activities of government while allowing governments the flexibility to implement their policy priorities, but ensuring they do so within a 'corridor of stability'.

The current arrangements for the operation of the Federation need to be reformed. This includes clarifying the roles and responsibilities and reforming Commonwealth-State financial relations. The Commonwealth will need to quit certain areas and, in return, the States will need access to and control over a more assured revenue base. Duplication between the Commonwealth and the States should be eliminated. New arrangements are also needed for sharing the proceeds of the GST.

Major reforms to the largest and fastest growing areas of Commonwealth spending offer the only real opportunity for managing and restraining growth in overall government expenditure. The Commission has identified reforms to the 15 largest and fastest growing spending programmes to ensure they can be placed on a more sustainable footing.

The government will have to rationalise and streamline many of the things it currently does and in some areas stop doing things completely. This includes rationalising the number of bodies and agencies, ceasing many grant programmes and other ineffective programmes, limiting industry assistance and streamlining other functions.

Government needs to better apply market based and technological solutions to improve the way many government services are delivered. This includes considering opportunities for privatisation, making better use of data and information technology and a commissioning of greater private sector expertise in the design and delivery of services including e-Government services.

PART B: A WAY AHEAD

5 – Approach to government and new fiscal rules

5.1 Fiscal framework and rules

The sustainability of Australia’s public finances is central to the Commission’s deliberations. It has been asked to assess the adequacy of current budget practices and rules (including specified timeframes and targets) in promoting efficient and effective government, disciplined expenditure, long-term fiscal sustainability and budget transparency.

The previous section outlined many of the challenges which lie ahead. One of these challenges — for all governments — is to develop credible strategies to strengthen public finances.

It has become increasingly difficult for governments to make the commitments needed over the medium term to create confidence that the future path of budget balances and public debt will be sustainable.

As outlined in Chapter Four, under the Commission’s ‘Business as Usual’ scenario the Commonwealth Government will face ongoing budget deficits from now until 2023-24. This would mean an unprecedented 16 years of successive budget deficits.

Fiscal settings need to be tightened, in a clear and transparent way, to enable the Commonwealth to move back to surplus and start paying down debt.

Without tightening, net debt will stay above its current level for the next decade. Having deteriorated by around 15 per cent of GDP since the global financial crisis, the danger is that a future macroeconomic shock would see Australia’s net debt level rise to levels not experienced for the past four decades.

Crises can take longer to arrive than people think, however they usually hit with great speed and severe consequences.

The imposition of clear fiscal rules and frameworks is one way of strengthening our defences against future crises.

Australia has had fiscal rules of some sort since 1985. *The Charter of Budget Honesty Act 1998* places a legislative requirement on Commonwealth Governments to uphold a level of budget transparency and fiscal responsibility. This is a good thing.

The Charter requires the government to release a fiscal strategy at its first budget to inform future policy decisions. The strategy should be based on principles of sound fiscal management and underpinned by a sustainable medium-term framework.

The fiscal strategy increases community awareness of government fiscal direction and establishes a benchmark for evaluating its conduct.

In keeping with the Charter's principles of sound fiscal management, a comprehensive fiscal strategy needs objectives around:

- the government's financial performance on an annual basis reflecting developments around tax collections and spending outcomes (for example, the need for budget surpluses);
- the health of the government's balance sheet (for example, the need to build up financial wealth or reduce outstanding debt over time); and
- constraining the size of government (for example by limiting government spending, or limiting government taxation).

Together these objectives would illustrate the government's annual financial performance and long-term sustainability of its finances as well as imposing a discipline to encourage responsible government.

There is a range of different indicators to measure these objectives. Possible annual (or flow) measures include objectives for the underlying cash balance, headline cash balance, fiscal balance, structural balance and net operating balance.

Possible measures for strengthening the balance sheet (the stock objective) include net debt, net financial worth, net financial liabilities, net worth and gross debt (defined as total Commonwealth Government Securities on issue).

Each of these indicators has strengths and weaknesses. One option would be to encompass a range of different indicators within the fiscal strategy. However, this leads to significant additional complexity, which could limit the broader usefulness of the strategy.

For simplicity and transparency, it makes sense to continue using underlying cash balance as the main flow indicator and net debt as the main stock indicator. Other measures would continue to be reported in the Budget papers, thereby allowing relevant comparisons as required.

Other fiscal rules, such as the Golden Rule and the Debt Brake Rule have been tried in European countries, but they are more complicated and have the same enforcement problems as simpler targets. Under a Golden Rule, governments balance recurrent spending and capital spending is excluded from the Budget balance. Further details on the Golden Rule and the Debt Brake Rule are included in the Appendix at Section 6.1.

Successive Commonwealth governments have adopted a broad fiscal strategy with high-level goals, underpinned by a set of operational rules which set out how the strategy will be achieved on a year-by-year basis. This gives governments the flexibility to implement their policy priorities within a framework that helps ensure the nation's finances are headed in the right direction.

However, as outlined above, in recent years the announced fiscal strategy has not succeeded.

Nonetheless, the Commission considers retaining the central elements of the fiscal strategy, in place for nearly two decades, is warranted to promote stability and consistency in Australia's overall fiscal framework.

Steps are now required to ensure the fiscal strategy is successfully executed. This requires a more prescriptive approach with a new set of operational rules to better frame fiscal policy choices and enable a better and more transparent assessment of governments' fiscal performance.

The Commission considers the surplus target of 1 per cent of GDP, included in its terms of reference, is appropriate and should be part of the new fiscal rules.

A surplus of this size is necessary to place net debt on a downward path.

While Australia's net debt is low by international standards, recent experience in the Eurozone and elsewhere suggests that shocks can have a dramatic impact on debt levels.

This being the case, a relatively low level of net debt is important, to ensure Australia has a buffer against such shocks. As the Australian economy is now more exposed to economies in our region which have higher levels of volatility, a fiscal buffer is even more important.

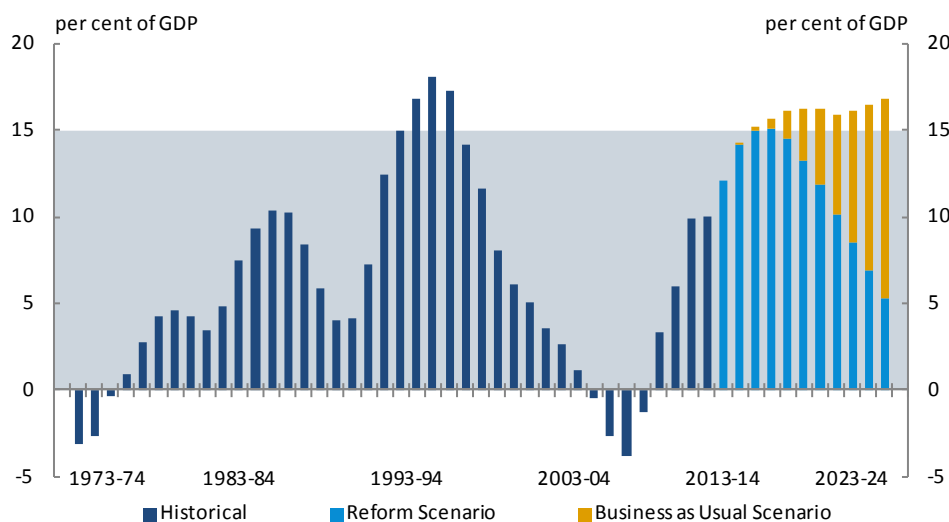
There is ongoing debate about the level at which government debt becomes problematic.

World financial markets are sensitive to a country's level of debt and can impose very high costs on governments with a large debt stock in the event of a major economic shock. Relatively low debt levels generally favour the ability of governments to manage their own budgets. Moreover there seems little doubt that economic, political and social costs over and above the interest cost of servicing debt rise with the levels of government and national debt.

High net debt can also have perverse effects on spending decisions. Government borrowings and a run up in debt can reduce the discipline of the Budget process. When additional government spending does not need to be matched by extra tax revenue, policy makers and the public will generally worry less about whether the additional spending is appropriate.

Since 1970, net debt in Australia has averaged less than 6 per cent of GDP. Other than in the period after the recession in the early 1990s, net debt has always been well below 15 per cent of GDP.

Chart 5.1: Commonwealth Government net debt (share of GDP)



Source: Mid-Year Economic and Fiscal Outlook 2013-14 and National Commission of Audit.

As shown in Chart 5.1, under the Commission’s ‘Business as Usual’ Scenario, Australia’s net debt rises above 15 per cent of GDP and remains elevated through to 2023-24 and beyond.

In contrast, under the ‘Reform’ Scenario (which produces a surplus of 1 per cent of GDP by 2023-24) net debt would decline to just over 5 per cent of GDP. Maintenance of small surpluses while economic conditions are sound beyond this time would see net debt reduce further.

The Commission considers that fiscal policy should be set with a view to reducing net debt over time.

In effect, this strategy of keeping net debt relatively low (or slightly negative) is designed to provide a ‘corridor of stability’ or safe harbour within which governments can operate. It will help ensure that the nation’s finances are kept in good order and act to shock-proof the economy from future crises.

Governments need the discipline of a rule on tax to GDP to limit the size of the burden of taxation on Australians.

A pragmatic approach should be to adopt a tax to GDP cap of 24 per cent which is around the average level of tax receipts recorded over the period from 2000 to the onset of the global financial crisis. It would allow for some growth to occur in the tax to GDP share from the current tax level of 21.8 per cent of GDP as the economy strengthens.

The three new rules — achieving a surplus of 1 per cent of GDP by 2023-24, substantially reducing net debt over time and ensuring tax receipts remain below 24 per cent of GDP — are predicated on the economy operating within a normal range.

In the event of a rare economic shock (for example of the order of the global financial crisis), the automatic stabilisers in the Budget should be allowed to operate, with discretionary fiscal policy used to support macroeconomic demand as appropriate.

In these circumstances, the core elements of the proposed rules would remain, possibly with an ‘escape clause’ which allows temporary adjustments to the timing and/or size of surplus target, so as not to damage short-run growth.

Conversely, a temporary boost to tax receipts — arising from, for example, an unexpected and marked rise in the terms of trade — that pushed taxes over 24 per cent of GDP could be accepted as long as it was temporary and the proceeds were not spent but used to pay down debt.

The prudent design of escape clauses can provide flexibility to rules in dealing with rare events and are advocated by the International Monetary Fund as an acceptable part of a suite of fiscal rules. They do, however, need to be carefully specified.

Recommendation 1: Fiscal framework and rules

The imposition of clear fiscal rules and frameworks is one way of strengthening the nation’s finances. The Commission recommends the Government adopt a high-level fiscal strategy which seeks to achieve underlying cash surpluses, on average, over the cycle; improve the government’s balance sheet over time; and limit the size of government, as a proportion of GDP.

It should do this by adopting the following fiscal rules which set out how the fiscal strategy is to be achieved on a year-by-year basis.

- Achieve a surplus of 1 per cent of GDP by 2023-24.
- Substantially reduce net debt over the next decade.
- Ensure taxation receipts remain below 24 per cent of GDP.

Monitoring progress against the fiscal strategy and rules

Currently, there is no official mechanism for reporting the government’s progress against, and adherence to, the fiscal strategy. Including such a mechanism would improve accountability and transparency of government’s fiscal situation and direction.

Within Australia, the Parliamentary Budget Office was recently established to inform the Parliament by providing independent and non-partisan analysis of the budget cycle, fiscal policy and the financial implications of proposals.

The Commission considers the Parliamentary Budget Office could play a formal role in assessing fiscal policy and tracking the government's decisions against the fiscal rules.

The Charter of Budget Honesty Act 1998 should be amended to require the Parliamentary Budget Office to report progress against the government's medium-term fiscal strategy following the release of the Final Budget Outcome each year.

Recommendation 2: Reporting against fiscal rules

To report the Government's adherence to the fiscal strategy, the Commission recommends the Parliamentary Budget Office report progress against the fiscal rules following the release of the Final Budget Outcome each year.

5.2 Better management of the Commonwealth's balance sheet

The government's balance sheet is an important measure of its financial position at a point in time.

While assessments typically focus on the annual 'bottom line' as measured by the underlying budget balance, the state of the Commonwealth's assets and liabilities matters a great deal.

The relative health of the Commonwealth balance sheet heavily influences credit ratings and therefore its borrowing costs. Not only is the balance sheet an important indicator of short term fiscal sustainability and government's ability to respond to economic shocks, it also reflects the debt and other liabilities that future generations must repay.

The Commission considers there are advantages in raising community awareness of the balance sheet's importance. A greater focus on it would broaden the debate on fiscal policy and encourage better asset management.

As outlined above, the Commonwealth holds some \$110.1 billion of non-financial assets, with responsibility for managing them on a day to day basis devolved to individual agencies. Section 10.1 considers the potential to privatise several Commonwealth entities and assets. Further recommendations for improving management of the Commonwealth's property portfolio are outlined in Section 10.2.

Prudent asset management practices suggest governments should adequately fund not only upfront expenditure on assets, but also ongoing capital maintenance and operating costs.

As described in Section 4.2, a significant pressure on the balance sheet is unfunded defined benefit scheme superannuation liabilities for public servants and military personnel. The Military Superannuation and Benefits Scheme is projected to be the main driver of the Commonwealth's superannuation liability growth from 2030.

The 2007 Report of the Review into Military Superannuation Arrangements recommended there be no change to the indexation arrangements for the current military superannuation scheme, that the scheme be closed to new entrants and a new scheme based on an accumulation plan be opened for new Australian Defence Force members.

The Military Superannuation and Benefits Scheme is now the only major Commonwealth scheme with unfunded defined benefits that remains open to new members, and hence is generating uncapped and increasing unfunded liabilities. These liabilities will have to be paid for by future generations.

Steps should be taken now to better manage them. Any changes must, however, recognise the obligation Australia has to look after our serving personnel. The Commission recommends that the Military Superannuation and Benefits Scheme be closed to new members and replaced by an accumulation scheme for new Australian Defence Force personnel. The new scheme should be designed in a way that recognises the special contribution these Australians make to the defence of the nation. Any new scheme should continue to provide a defined benefit where a member dies or is medically discharged from the Defence Force. This death and disability element will complement the accumulation component of the scheme.

Closure of the Military Superannuation and Benefits Scheme would result in a significant reduction in the Commonwealth's unfunded superannuation liability potentially in the order of \$200 million by 2020. This would make a significant contribution to repairing the long-term financial position of the Commonwealth.

If the Military Superannuation and Benefits Scheme is closed and replaced by a funded accumulation scheme for new military personnel there will be an immediate increase in cash costs to government. This arises because employer contributions would be made directly to the new scheme in respect of members' services, whereas the reduction in outlays from closing the Military Superannuation and Benefits Scheme arises from reduced pension payments in the longer term.

While the increased cash outlays would depend on the design of the new scheme, including the contribution rate and death and disability arrangements, these outlays over the first four years could be around \$400 million.

As outlined above, the Future Fund was established to enhance the ability of the Commonwealth to discharge annual unfunded superannuation benefit payments. Under current arrangements, draw downs from the Future Fund will occur from 2020.

The effect of drawing down pension payments, from that date, will be a decrease in cash costs to government, as payments will be met from Future Fund monies rather than consolidated revenue.

In relation to civilian superannuation, while the major defined benefit schemes have been closed already, the liability will nevertheless continue to grow until around 2030 in relation to existing contributors.

The Government should move over time to a ‘funded’ model for those defined benefit schemes, where the employer contribution would be paid to the superannuation trustee, the Commonwealth Superannuation Corporation, rather than retained in consolidated revenue. This is the arrangement the Commonwealth currently follows for its accumulation schemes.

This would reduce the Commonwealth’s medium to long-term liability, but lead to a significant and immediate increase in cash costs to government, estimated to be around \$1.4 billion per year. If this option is also implemented in relation to the existing military scheme, this cost would rise to about \$2.7 billion per year.

Given the significant cash impacts of funding future employer contributions, the Government should consider allowing earlier drawdowns from the Future Fund (that is, before 2020). This would effectively offset, in part or full, the costs of a new accumulation scheme and, or the funding of defined benefit schemes in future years. This action would require amendments to the *Future Fund Act 2006*.

Recommendation 3: Better balance sheet management – unfunded superannuation liabilities

Unfunded superannuation liabilities on the Commonwealth’s balance sheet represent a significant risk to the long-term financial position of the Commonwealth and should be better managed. The Commission recommends that the Government:

- a. close the Military Superannuation and Benefits Scheme to new entrants, with a new scheme established based on an accumulation plan opened for new Australian Defence Force members;
- b. as part of prudent financial management, move over time to a ‘funded model’ for existing defined benefit superannuation schemes; and
- c. in recognition of the upfront costs of a ‘funded model’ approach, consider allowing earlier drawdowns from the Future Fund to offset the costs of the new military accumulation scheme and future funding of existing defined benefit schemes. This would require amendments to the *Future Fund Act 2006*.

More generally, in considering issues around the balance sheet it is important to recognise governments take risks onto their balance sheet when they provide guarantees and loans (including concessional loans) to various people and organisations.

Recent examples include: the guarantee of \$700 billion of deposits as part of the Financial Claims Scheme; guarantees of \$13 billion of aged care accommodation bonds; guaranteeing \$3.3 billion of liabilities of the Export Finance and Insurance Corporation; and loans through the Clean Energy Finance Corporation.

The information on the attendant risks provided to ministers and released publicly on these guarantees and loans is relatively poor.

The expected costs of guarantee calls and most loan defaults are not included in the Budget estimates. This means guarantee and loan costs are not budgeted for on an equivalent basis to the costs of more direct forms of government expenditure, like grants.

By failing to properly price the risk taken on by government, guarantees and loans are not subject to an effective budget constraint, they cannot be prioritised or ranked against other direct forms of expenditure. Government also has an incentive to take on more risk on behalf of taxpayers than is warranted.

The Commission considers the practice of government providing guarantees and loans would benefit from greater transparency through better budget treatment.

The expected costs of all existing and new Commonwealth guarantees should be included in the Budget both in the Budget year and forward estimates. The cost would be determined as an expected value of the guarantee being called (assessed as a probability applied to the amount of the guarantee).

The Contingency Reserve is an allowance used to ensure estimates are based on the best information available at the time of the Budget and to ensure aggregate estimates are as close as possible to expected outcomes. It includes a provision for events and pressures reasonably expected to affect the Budget estimates. The expected costs of guarantees could be included in the Contingency Reserve under this category.

Where the costs materialise they would be booked within the appropriate agency and the amount in the Contingency Reserve would be removed. Where these costs do not eventuate the amount would be backed out from the Contingency Reserve at the end of each year.

For loans, the Commonwealth should recognise the expected amount of loan defaults as a grant at the time of the loan origination. There is already scope under existing accounting standards to recognise the expected costs of loan defaults as a grant in the Budget estimates.

This change in budget treatment would remove the current perverse incentive for guarantees and loans to be viewed as ‘costless’ forms of assistance. If, as is possible, such assistance is effectively prioritised against other direct forms of expenditure it should reduce the incentive for governments to take on more risk on behalf of taxpayers.

At a decision making level, a proposing minister could be required to offset the expected costs of guarantees or loans. Expected costs could also be charged in full or in part to the beneficiary.

Recommendation 4: Better balance sheet management – loans and guarantees

There are risks to the Commonwealth’s financial position when the government provides guarantees and loans. The Commission recommends:

- a. the expected costs of existing and new Commonwealth guarantees be included in the Contingency Reserve across the forward estimates (and removed from the Contingency Reserve at the end of each year if the costs do not eventuate);
- b. the expected non-repayment amount of loans be recognised as a grant at the time of loan origination;
- c. the expected costs be included in the Budget where they can be reliably estimated and have an expected cost above \$5 million in any year; and
- d. the Commonwealth continue to regularly and independently re-assess the value of its guarantees and loans.

The government also takes on the risks of ownership and receives returns (such as dividends) on behalf of taxpayers when it partially or fully holds equity. Equity holdings in major government-owned entities include NBN Co, Medibank Private and Australia Post.

Under the relevant accounting standards, the Commonwealth’s equity investments are classified as having no impact on the Budget ‘bottom line’ (the underlying cash balance) if the Commonwealth has a reasonable expectation of a real return on its investment, at least covering the effects of inflation.

For example, the Budget papers record the financing of NBN Co as an equity investment on the basis that the Commonwealth expects to recover its outlay in real terms over time through dividends and sale of the investment in the future.

This ‘hurdle rate of return’ (of around 3 per cent) for the Commonwealth is well below that required by a private investor, who would require a rate of return commensurate with the cost of borrowing and the level of risk undertaken. Under the Government Financial Statistics accounting standards there is no requirement for NBN Co or other equity investments to achieve a risk-adjusted rate of return.

Without commercial discipline, government-owned entities may accept a lower rate of return and take on more risk. While the Commonwealth has a low cost of borrowing by virtue of its ability to source debt and raise tax, this does not mitigate the risks taken on by taxpayers from the financing of risky projects.

The annual change in the value of equity in NBN Co is presented as an 'other economic flow' on the balance sheet. Should the Commonwealth no longer expect to receive a real return on its investment, any future equity injections would be classified, partially or fully, as grants. This would worsen the underlying cash balance.

As outlined in Section 10.1, the Commission considers that Commonwealth bodies that operate and compete in contestable markets should be considered for their privatisation potential.

Similarly, as a matter of policy, the Commonwealth should not take equity positions where the activity can be undertaken by the private sector, with private investors, rather than taxpayers, risking their own money.

Where the Commonwealth does take an equity position it should disclose the rate of return it expects to receive and how this compares to the risk-adjusted rate of return that a private investor would need to make the same investment.

Recommendation 5: Better balance sheet management – equity investments

Without commercial discipline, government-owned entities may accept a lower rate of return and take on excessive risk. The Commission recommends:

- a. the Commonwealth not take equity positions where the activity can be undertaken by the private sector;
- b. where the Commonwealth does take an equity position it should disclose the rate of return it expects to receive and how this compares to the risk-adjusted rate of return that a private investor would require to make the same investment; and
- c. the Commonwealth continue to regularly and independently re-assess the value of its equity investments.

5.3 Budget reporting and the Charter of Budget Honesty

Budget transparency allows for a more informed debate, fosters credibility and helps the community better understand fiscal policy. Improved fiscal transparency can assist in highlighting current and emerging fiscal risks and in driving the necessary change in the community's expectations of government.

The *Charter of Budget Honesty Act 1998* mandates certain budget reporting – the Budget, Mid-Year Economic and Fiscal Outlook and Final Budget Outlook documents for each financial year, the Pre-Election Economic and Fiscal Outlook ahead of elections and periodic release of the Intergenerational Report. However, the Charter provides relatively little guidance on the required content of these reports.

The Commission considers there is scope for improving the transparency of budget reporting.

Responsible economic management should not only consider the near-term but also the medium to longer term.

There is no requirement for budget updates to include aggregate budget estimates any further than three years beyond the Budget year. However, at an aggregate level, medium-term projections have been published in budget updates for the past few years.

The Commission considers current practices around publishing medium-term budget information should be further developed.

The Charter of Budget Honesty should be changed to make it mandatory for each fiscal update to include projections for the 10 years beyond the Budget year for key budget aggregates. This would include aggregate spending as well as revenue receipts. The projections should be based on current policy settings as far as practicable.

Moreover, individual budget measures relating to new policy decisions that will have a substantial impact beyond the forward estimates should include financial information for the decade beyond the Budget year.

The Commission considers this approach will hold governments more accountable for their fiscal strategy.

The Charter of Budget Honesty also currently requires the government to release an Intergenerational Report at least every five years. This report examines the long-term sustainability of current policy over 40 years and includes the financial implications of demographic change.

The Commission considers the preparation and publication of regular Intergenerational Reports has been a positive development for Australia, particularly in raising awareness of the budgetary challenges of the ageing population.

It should be retained as a key document to increase budget transparency. There should be a requirement that it be produced within a specified period after the release of the National Census. In addition, the Commission considers that future reports should also cover the long-term sustainability of State and Territory budgets. This will require significant cooperation with the States as well as requiring Commonwealth bodies to provide relevant information to assist in the preparation of the whole of nation Intergenerational Report.

Recent budget documents have reported large downward revisions to the economic and revenue forecasts creating concerns about forecasting.

The Commission notes that compared with some jurisdictions overseas, Australia's formal official forecasting processes do not include formal discussions with independent experts.

However, the Commission considers additional transparency can be achieved by publishing comparisons between key economic forecasts used in the fiscal update and relevant consensus forecasts. Confidence intervals should also be published for key forecasts.

Each year's budget documentation includes a discussion of the possible impact of economic developments on estimates. This analysis considers the effects on receipts and payments of altering some of the key economic assumptions. This sensitivity analysis should be improved by using different scenarios and incorporating more analysis of the way variations to programme parameters change costs.

At a bureaucratic level, the requirements of the government's fiscal strategy are operationalised through the Budget Process Operational Rules, which provide guidance to departments and agencies on processes and costing requirements.

These operational rules are classified documents and not available for broader circulation. This limits transparency and public understanding of the budget process. While operational rules require identification of the longer-term costs of budget proposals, these are often not reflected in public budget documentation. This lack of long-term fiscal reporting can reinforce governments' focus on a three-year electoral or a four-year budget cycle.

The Commission considers Budget Process Operational Rules should be released publicly to enhance understanding of how budgets are framed.

In recent years the size and complexity of budget documentation has grown significantly without contributing to improved fiscal policy debate. The size and complexity makes the budget documents hard to navigate for a wider audience.

The Commission considers reducing budget documentation could assist in communicating budget narratives.

In terms of the presentation of key budget aggregates in the Budget documentation, the Commission considers that emphasis should be on three measures:

- the underlying cash balance;
- the net debt position; and
- the net financial worth of the Commonwealth.

This would assist in giving greater prominence to and raising public awareness of the broader financial position including the state of the Commonwealth's balance sheet.

Recommendation 6: Budget reporting and the Charter of Budget Honesty

Budget transparency allows for a more informed debate about the state of the Budget and fosters accountability. The Commission recommends improvements to the transparency of fiscal processes and budget reporting by requiring that:

- a. fiscal updates set out projections for key budget aggregates for 10 years beyond the Budget year;
- b. the Intergenerational Report be prepared within a specified period after the release of the National Census and that it be extended to also include analysis of the long-term sustainability of State and Territory budgets;
- c. fiscal updates should compare key economic forecasts and relevant consensus forecasts;
- d. sensitivity analysis in budget documents be improved;
- e. the Budget Process Operational Rules be released to enhance public understanding of how budgets are framed; and
- f. the Budget documentation give particular prominence to:
 - the underlying cash balance;
 - the Commonwealth's net debt position; and
 - the net financial worth of the Commonwealth.

6 – Reforming the Federation

As outlined in Chapter Three, the current operation of Australia's Federation poses particular challenges to the delivery of good, responsible government.

Achieving productive reform in our Federation offers significant potential for better government. The competitive dimension of a federation can inject the right incentives into the system for governments to improve public sector efficiency. It can also improve accountability and encourage more responsive government.

The Commission was invited to comment upon the current architecture of Commonwealth-State financial relations and asked to assess the current split of roles and responsibilities between the Commonwealth Government and State and Territory governments.

The Commission recommends that the degree of vertical fiscal imbalance within the Federation be substantially reduced with a corresponding reduction in the Commonwealth's taxation revenue.

This would have a beneficial impact on the efficiency and effectiveness of governments. It would also increase the accountability of Commonwealth and State governments as the link between their taxing and spending decisions would be clearer to their electorates.

Any reform of financial arrangements cannot be done in isolation of the need to rationalise the duplication of expenditure responsibilities between different levels of government.

The Commission has examined four related areas:

- rationalising roles and responsibilities;
- addressing the issue of vertical fiscal imbalance;
- adopting a new approach to horizontal fiscal equalisation; and
- reducing the administrative burden imposed by federalism.

The time has arrived to be ambitious and bold in reforming and improving Australia's Federation.

6.1 Roles, responsibilities and duplication

A number of examples of duplication and overlap between the Commonwealth and the States were outlined in Chapter Three, including in the areas of health, education and housing.

A thorough reassessment of roles and responsibilities across levels of government is needed as a matter of urgency.

In determining 'who should do what' the Commission considers that two key principles should apply - subsidiarity and sovereignty.

Under the principle of subsidiarity, policy and service delivery should, as far as practicable, be devolved to the level of government closest to the people receiving the services. This recognises that sub-national governments are likely to have greater knowledge about the needs of citizens affected by their policies. It allows programmes to be tailored to meet community needs.

Governments should also operate at their natural levels. Policy oversight for national issues should go to the Commonwealth with responsibility for regional and local issues predominantly going to State and Territory governments.

Under the principle of sovereignty, as far as practicable, each level of government should be sovereign in its own sphere.

When reviewing roles and responsibilities, government activities should be allocated to one level of government where possible. This will provide greater clarity and accountability.

Any changes to roles and responsibilities should not result in major changes to the level of service currently provided to the public.

It will be essential that the States have a deep involvement in any review of roles and responsibilities. Most substantial reforms will require the Commonwealth and State governments to work together to determine who is the appropriate service provider. Having done that, an assessment can be made of the required level of funding. It would then be incumbent on governments to explain this to the broader public.

The Commission has identified a number of major Commonwealth spending areas, where it considers that there are near term opportunities to reduce overlapping responsibility and duplication. This is particularly the case for schools (Section 7.7), vocational education and training, housing, mental health and natural disaster relief funding (Section 8.6).

Recommendation 7: Reforming the Federation – clarifying roles and responsibilities

There is significant overlap between the activities of the Commonwealth and the States. The Commission recommends that a comprehensive review of the roles and responsibilities between the Commonwealth and State governments be undertaken, informed by:

- a. the principle of ‘subsidiarity’ so that policy and service delivery is as far as is practicable delivered by the level of government closest to the people receiving those services;
- b. ensuring that each level of government is sovereign in its own sphere; and
- c. ensuring minimal duplication between the Commonwealth and the States and, where overlap cannot be avoided, ensuring appropriate cooperation occurs at all times.

6.2 Addressing vertical fiscal imbalance

The Commission strongly considers the time has come for there to be a closer matching of revenue-raising capacity of the States with their expenditure responsibilities.

Options to reduce vertical fiscal imbalance have been examined in Australia over many decades.

In 1991, the Working Party on Tax Powers to the Special Premiers Conference noted that it is a basic tenet of a democratic system that the success with which governments perform their roles depends a great deal on the extent to which they are accountable to the community.

This Working Party put forward a number of options which worked to increase the fiscal autonomy of the States.

At the time, it was noted that the options under consideration would involve:

fundamental changes to the relationships between the various levels of government as well as the tax system of the nation. Changes of this nature have far-reaching effects on the community and, while that is no reason for avoiding change, it does argue for very careful consideration.

The Commission endorses the sentiment of the Working Party’s observations. It considers that the most realistic option for addressing the current vertical fiscal imbalance would be to increase State and Territory revenue capacities by providing them with access to the Commonwealth’s personal income tax base.

The Commission supports an arrangement whereby the Commonwealth would lower its personal income tax rates to allow room for the States to levy their own income tax surcharge.

The impact of lower revenue collections for the Commonwealth would be offset through an equivalent reduction in the payment of other Commonwealth financial assistance to the States. In other words, the financial implication would simply be a substitution of a new untied source of revenue to the States (through the personal income tax system) to replace a series of tied grants.

By way of illustration, the Commonwealth could permit States to access the personal tax base directly by reducing the current personal income rate of 32.5 per cent (which applies on incomes from \$37,000 to \$80,000) by 10 percentage points to 22.5 per cent.

A 10 percentage point 'State income tax surcharge' could be introduced to bring the overall rate back to 32.5 per cent. This 10 percentage point State surcharge would be hypothecated to the States providing them, in this example, with an estimated additional revenue source of around \$25 billion per year.

To offset this, the Commonwealth would take \$25 billion out of the \$45 billion in tied grants it currently provides to the States. Included in the \$25 billion, for example, could be the tied grants currently provided for schools and the tied grants paid through the various National Partnership Agreements.

It would also be possible to extend the income tax sharing arrangement by allowing the States to periodically adjust the surcharge rate (either up or down by several percentage points). This has the potential to inject further competitive tension within the Federation as States would have the autonomy to set rates and compete amongst themselves.

The Commission recognises that such a reform would represent a material change in the current financial arrangements and that there would be legal, technical and administrative details to resolve. However, there is no general legal limitation on State parliaments imposing income tax.

The opportunity for States to do so was in fact provided by the Commonwealth in the 1970s but States did not take up the offer (in part because the Commonwealth was not prepared to make room by lowering its rates).

A change in current arrangements to permit the States to levy an income surcharge would have to take account of the Commonwealth's requirement to implement its broader macroeconomic and income distribution responsibilities.

Such an arrangement may, therefore, require an agreement between the Commonwealth and the States on future changes to personal income tax brackets and thresholds.

Other options for reducing the current level of vertical fiscal imbalance also exist, including the prospects for the States to extract more revenue from their existing tax bases, changing arrangements for the GST, or through the Commonwealth simply providing a greater proportion of existing financial assistance in the form of untied grants.

To the extent that these options do not promote greater competitive federalism, they are not supported.

Nonetheless the Commission sees merit in re-examining the base and rate of the GST as part of broader tax reform. To the extent that the overall tax burden should not increase, any changes to the GST should be offset by the elimination of other inefficient State taxes, including stamp duties and insurance taxes. Such reform would not improve vertical fiscal imbalance, but would lead to a more efficient tax system and improve Australia's overall growth prospects.

Recommendation 8: Reforming the Federation – addressing vertical fiscal imbalance

A closer matching of the revenue-raising capacity of States and Territories and their expenditure responsibilities would make them more responsible in their own sphere. The Commission recommends that:

- a. the degree of vertical fiscal imbalance in the Federation be substantially reduced. This should be achieved by providing the States with access to the Commonwealth's personal income tax base;
- b. to facilitate this proposal, the Commonwealth should make room and reduce its personal income tax rate by an equivalent percentage point amount to a new State surcharge to ensure that taxes do not rise overall. Revenue raised would be hypothecated to the States; and
- c. the States be provided with a capacity to periodically vary the surcharge they impose as a means of injecting further competition into the Federation.

6.3 Improving horizontal fiscal equalisation

As outlined in Chapter Three, it is usual for individual states within a federation to have different capacities to raise revenue or deliver services. The practice of equalising capacities through various forms of fiscal equalisation has occurred in Australia since 1901.

Under the *Intergovernmental Agreement on Federal Financial Relations*, the States are entitled to receive payments from the Commonwealth equivalent to the revenue received from the GST. The allocation of GST revenue between States is currently set in accordance with the recommendations of the Commonwealth Grants Commission.

This is a well established process, but it is nonetheless contentious.

The 2012 GST Distribution Review into this matter found that the 'recipient' States support the existing equalisation system while the 'donor' States see many problems with it. The second group of States represent some 90 per cent of Australia's population.

The GST Distribution Review presented a comprehensive series of recommendations, but did not recommend fundamental change to the equalisation system over the short to medium term. It noted that 'it is not possible to closely replicate the outcomes of the current system in a dramatically simpler way'.

It is important to appreciate the link between vertical fiscal imbalance and horizontal fiscal equalisation. If steps are taken to reduce vertical fiscal imbalance, as proposed in the previous section, States' revenue raising capacities would be better linked to their service delivery responsibilities, and a substantially simplified form of horizontal fiscal equalisation could apply.

In reducing vertical fiscal imbalance it would be possible to move to a model where there was minimal redistribution between the current donor States (New South Wales, Victoria and Western Australia) as well as Queensland, but with targeted distribution towards the current recipient States (South Australia, Tasmania, the Australian Capital Territory and the Northern Territory).

Since the introduction of the GST, the fiscally-stronger States have consistently received around 80 per cent of the pool collectively, while the recipient States have received around 20 per cent of the GST pool (about twice their population share).

One option would be for all States to receive an equal per capita distribution of GST collected. Such a distribution would leave the donor States better off compared to existing arrangements.

To preserve the current share of the fiscally-weaker States, responsibility for ensuring these States' fiscal wellbeing could be addressed by the Commonwealth Government. That is the Commonwealth would make 'top up' payments out of its own revenue base.

The GST Distribution Review noted that in this situation the question would be what level of funding should be provided by the Commonwealth to the smaller States for the purpose of horizontal fiscal equalisation.

The current 20 per cent of GST pool share or a set proportion of GDP could be used as the basis for determining this additional amount. The Commonwealth Grants Commission would retain a role in determining the basis for the allocation of this additional amount among the smaller States. A similar approach is currently used in Canada.

An indicative representation of how an alternative arrangement might work is shown in table 6.1 below.

Table 6.1: Impact of alternative approach to Horizontal Fiscal Equity

State	Current Distribution (\$ million)	Equal per capita Distribution (\$ million)	Illustrative new distribution (\$ million)
NSW	15,558	16,053	16,053
VIC	11,320	12,479	12,479
QLD	10,741	10,133	10,741
WA	2,458	5,493	5,493
SA	4,595	3,629	4,595
TAS	1,801	1,111	1,801
ACT	1,022	834	1,202
NT	2,756	517	2,756
Total	50,250	50,250	55,119

Source: Budget Paper No. 3, 2013-14 and National Commission of Audit.

Under these arrangements, the Commonwealth Government would need to fund an additional \$4.9 billion in equalisation payments if the goal was to ensure that no State was worse off than they are today. That is, as well as providing the States and with the full amount of GST collected, the Commonwealth would provide an additional \$4.9 billion that would be sourced from elsewhere in the Commonwealth's existing revenue base.

Such an approach offers substantial gains in efficiency and reduced complexity, which could also be taken further by a more general approach to reduce reporting burdens.

Recommendation 9: Reforming the Federation – arrangements for addressing horizontal fiscal equalisation

The practice of fiscal equalisation between the States is a central and longstanding feature of our Federation. The Commission recommends that, as part of a reformed approach to addressing vertical fiscal imbalance, new arrangements also be implemented to address issues with horizontal fiscal equalisation. This would involve:

- a. sharing all GST revenue on an equal per capita basis;
- b. the Commonwealth providing an additional grant to current recipient States to ensure that no State is worse off compared to the existing equalisation process; and
- c. distribution of the additional equalisation grant from the Commonwealth being determined by the Commonwealth Grants Commission.

6.4 Reforming financial arrangements – the quid pro quo

If the Commission's recommendations to address vertical fiscal imbalance and adopt a new approach to horizontal fiscal equalisation were pursued it is possible that the States would get access to a considerable amount of additional revenue.

On the illustrative basis outlined above, the additional revenue could equate to some \$30 billion per year (comprising \$25 billion of income taxation revenue and \$4.9 billion in top up payments as additional equalisation funding).

With no other changes, the Commonwealth would be out of pocket by this additional amount. The purpose of these changes, however, would not be to provide the States with a windfall gain, but rather to provide them with access to revenue sources that grow in line with growth in the economy and that provide them with a greater share of untied funding.

As part of any agreement to move to new financial arrangements within the Federation, it would be necessary to negotiate a transfer of responsibilities for areas of spending where the Commonwealth currently makes tied grants.

The Commission notes that total grants provided to the States in 2013-14 are around \$45.1 billion. Of this total, around \$13.9 billion is for National Health Reform Funding, \$13.2 billion for specific payments in education and \$3.9 billion in other payments for specific purposes for skills, disability and housing. The remaining \$14.0 billion is made up of payments under 144 different national partnership agreements.

Table 6.2 below provides an illustrative comparison of the current arrangements and potential arrangements that could prevail should the approach of addressing vertical fiscal imbalance through income tax sharing occur along with the revised approach to horizontal fiscal equalisation.

In the example outlined, the additional \$30 billion in revenue received by the States from the Commonwealth would be offset by lower tied grant payments.

One possibility would be for responsibility for schools funding to be transferred from the Commonwealth to the States. The \$13.2 billion that the Commonwealth current provides through the National Schools specific purpose payment would no longer be paid, with the States instead using the proceeds from having access to the personal income tax base available to more than fund this area of activity. A discussion of aspects of this option is outlined in Section 7.7 below.

Other existing tied grants including many of the National Partnership Agreements could also be abolished.

Under the illustrative arrangements outlined below, the amount of tied funding received by the States from the Commonwealth would reduce from \$45.1 billion to \$15.2 billion.

It would be possible for the Commonwealth and States to negotiate different ways of reallocating the responsibilities that would open up under the greater untied funding amounts provided.

Some of these issues are discussed in Section 6.5 below.

Table 6.2: Illustrative impact of changes to the architecture of federal financial arrangements

	Current Architecture (\$ billion)	Illustrative Architecture (\$ billion)
GST Revenue and existing general revenue assistance	51.2	51.2
Commonwealth Grants to States		
National Health Reform Funding	13.9	13.9
School Specific payments	13.2	0.0
Skills & Workforce Specific Payments	1.4	0.0
Disability Specific Payments	1.2	1.2
Affordable Housing Specific Payments	1.3	0.0
National Partnership Agreements	14.0	0.0
Total Grants	45.1	15.2
Access to personal income tax base	0.0	25.0
Additional equalisation payment	0.0	4.9
Total Commonwealth transfers to States	96.3	96.3
<i>Tied transfers</i>	<i>45.1</i>	<i>15.2</i>
<i>Untied transfers</i>	<i>51.2</i>	<i>81.1</i>

Source: Mid-Year Economic and Fiscal Outlook 2013-14 and National Commission of Audit.

Recommendation 10: Reforming the Federation – reduced tied grants to the States

Proposed changes to financial arrangements within the Federation should involve a transfer of responsibilities for areas of spending where the Commonwealth currently makes tied grants.

The Commission recommends that, should reforms be made to address vertical fiscal imbalance and horizontal fiscal equalisation as outlined above, existing tied grants from the Commonwealth to the States should be reduced by an amount equivalent to the additional untied revenue received by the States. Determining which grants would be reduced would be a matter for negotiation.

6.5 Reducing the administrative burden

A key objective of the *Intergovernmental Agreement on Federal Financial Relations* (the Intergovernmental Agreement) was a reduction in administration and compliance overheads. With its introduction in 2009, this agreement saw a rationalisation of the number of payments to the States, along with an increase in the overall quantum funding.

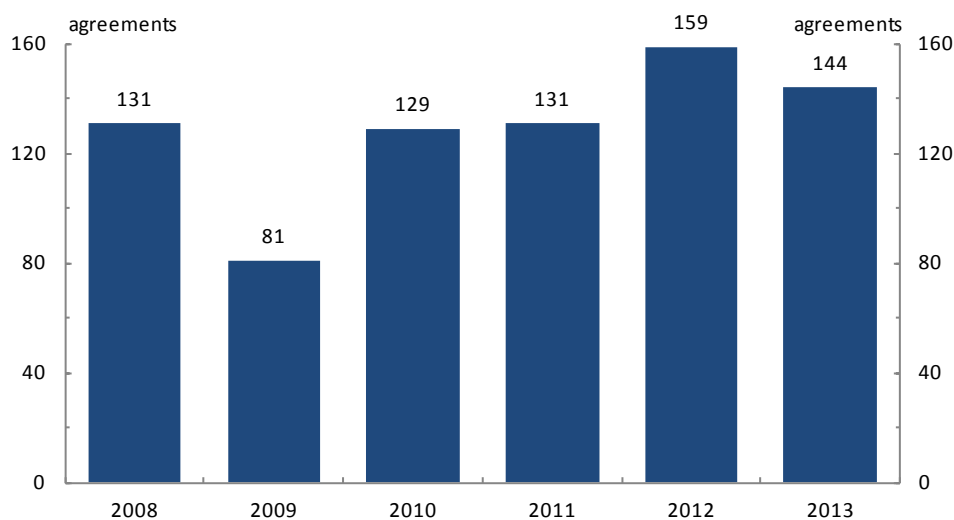
Any changes to Commonwealth-State financial architecture along the lines outlined above would represent a substantial change to the existing framework. The detailed design and ultimate implementation of any changes will be a complicated exercise that will take considerable time and effort.

In the meantime, however, steps need to be taken to vastly simplify the large number of existing Commonwealth State agreements.

As at 1 July 2013 there were 144 agreements in place under the Intergovernmental Agreement. See Chart 6.1.

Queensland has identified 19 intergovernmental agreements which are active, under development or recently expired, which together total only \$33.4 million in funding.

Chart 6.1: Total number of Commonwealth-State Agreements



Source: Department of Treasury.

Along with the administrative cost of developing the number of agreements, there is a growing reporting burden. The growth in the number of agreements has contributed to a significant growth in reporting and administrative expenses.

Furthermore, the Commonwealth has progressively moved back towards more detailed reporting arrangements in order that Commonwealth Ministers and the broader public can have certainty that taxpayers' money was being spent efficiently and in the areas required.

However, an additional bureaucracy is required to develop, report on, review and assess the agreements, which takes resources away from service delivery and gives rise to second guessing and duplication.

Steps should be taken to immediately review all National Partnership Agreements with a view to rationalising their number. This would reduce the administrative burden for both Commonwealth and State governments.

At the same time, it would be useful to re-examine performance reporting requirements, along with broader data and transparency requirements. This could incorporate a review of the current role of the COAG Reform Council.

The COAG Reform Council has responsibility for reporting on the performance of governments against National Agreements and National Partnerships.

The COAG Reform Council is the independent monitor of performance of jurisdictions in fulfilling their responsibilities under the Intergovernmental Agreement. However, the COAG Reform Council is one of a growing number of national performance reporting bodies.

The Council of Australian Governments itself has often been criticised as being slow and unnecessarily bureaucratic, slowing down rather than facilitating reform processes. It has also been seen as overly focussed on short-term 'announceables' rather than longer-term reform goals.

There needs to be a balance between the appropriate level of reporting to achieve the accountability desired to assess outcomes and at the same time keep the flexibility and efficiency required for service delivery.

A more streamlined system built around a single, integrated, national reporting system would reduce data collection costs and confusion in interpreting performance. Governments need to better consolidate data, streamline and simplify systems and reporting to improve clarity and make government decision making more transparent.

If a substantial rationalisation of National Agreements and National Partnerships could be achieved, alongside a streamlining of reporting and data requirements, then the role of the COAG Reform Council would be substantially diminished.

The COAG Reform Council could then be abolished as a separate entity, with its reporting role assumed by the Productivity Commission (which already has a strong government reporting focus).

Recommendation 11: Reforming the Federation – Reducing the administrative burden

Steps need to be taken to simplify the large number of existing Commonwealth-State agreements and associated reporting arrangements. The Commission recommends:

- a. the administrative burden between the Commonwealth and State governments be substantially reduced by rationalising the number of National Partnership Agreements and streamlining and reducing reporting requirements; and
- b. the COAG Reform Council could be abolished with its reporting role and staff moved to the Productivity Commission.

7 – Managing expenditure growth

Major reforms to the largest and fastest growing areas of Commonwealth spending offer the clearest opportunities for managing and restraining growth in overall government expenditure.

This Chapter examines 15 major policy areas and considers options that could be pursued to improve the effectiveness of programmes and to better manage overall expenditure growth.

7.1 Age Pension

The Age Pension provides basic income support for those Australians who are above retirement age but are not able to fully support themselves with their own means.

The Age Pension was introduced in 1909 and was accessed by a small proportion of the population given the qualification age was 65 and male life expectancy at birth was 55.

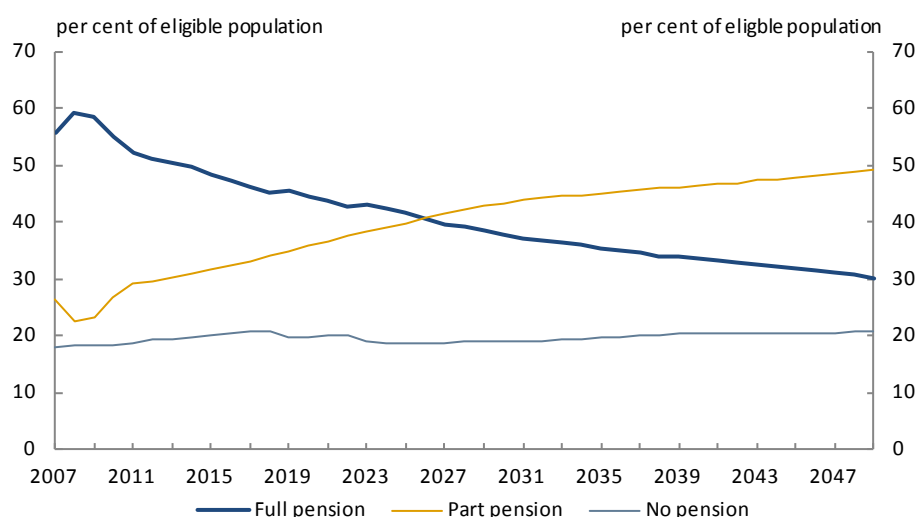
In 2009, the Commonwealth implemented the recommendations of the Harmer Pension Review, which increased the benchmark for the singles rate of the Age Pension from 25 per cent to 27.7 per cent of Male Total Average Weekly Earnings, and scheduled the age of access to the pension to rise from 65 to reach 67 by 2023.

In 2013-14, an estimated \$39.5 billion will be spent on the Age Pension, benefitting 2.4 million recipients. Expenditure on the Age Pension is currently growing at 7 per cent per year. Age Pension expenditure is expected to continue to increase largely as a result of an ageing population, increased life expectancies and benchmarking to the Male Total Average Weekly Earnings benchmark.

The features of the Age Pension means test, such as a 50 per cent taper rate and high income free area, can mean pensioners with relatively high levels of income (up to \$47,000 in annual income) are able to access a part-rate pension.

As shown in Chart 7.1 on current projections there is unlikely to be an increase in the proportion of individuals who are completely self-sufficient and not reliant on the Age Pension despite the significant investment in superannuation over time. Even allowing for a decline in the proportion of people receiving the full pension, a rise in the number of people receiving the part-rate pension will see the proportion of older Australians eligible for the Age Pension remaining constant at 80 per cent over the next forty years or so.

Chart 7.1: Projected proportion of eligible persons receiving an Age Pension



Source: Rothman, 2012.

In the Commission’s view the Age Pension should be regarded primarily as a social safety net, with the objective of providing security for older Australians who are unable to support themselves in their retirement. Older Australians with the resources to fund their own retirement should do so.

The Commission considers that changes are needed to ensure that the cost of the Age Pension remains sustainable and affordable and well targeted to those in genuine need.

Many Australians make significant decisions in the lead up to their retirement and it is essential that ample warning be provided to future retirees of any significant changes to Age Pension arrangements. The approach should be to phase in implementation of major changes to avoid significant impacts for those in retirement or those nearing retirement.

The Age Pension Benchmark

Historically, Age Pension rates have been set with regard to community standards through linking the rate of payment to wages rather than simply maintaining the payment in real terms. This ensures that a pensioner’s standard of living continues to have some reference to the incomes of the broader community.

The Age Pension has increased over time, not just in real terms but also relative to wages earned by those in paid employment. This is occurring in the context of an ageing population.

A summary of changes in the real value of the Age Pension over time is outlined in Section 9.1 of the detailed Appendix to this report.

The rate of the pension is currently linked to Male Total Average Weekly Earnings. The policy rationale for using this benchmark is weak as the increase in female labour force participation means a wage measure covering only males is an anachronism in the context of contemporary Australia.

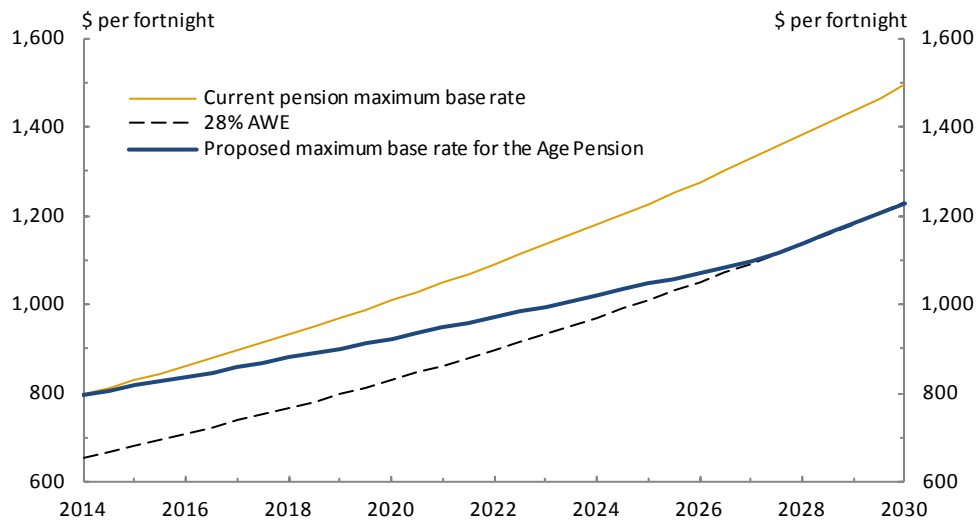
Average Weekly Earnings is a more appropriate benchmark for the rate of the pension, given that women are a major part of the labour force. Benchmarking to Average Weekly Earnings still recognises that pensions should have regard to community standards through benchmarking to wages.

It is proposed that the maximum base rate of the Age Pension be changed over time to be equal to, and then grow in line with, 28 per cent of Average Weekly Earnings.

The re-alignment over time could be achieved by indexing the current maximum base rate of the Age Pension to the higher of the growth in the CPI or the Pensioner and Beneficiary Living Cost Index until it reaches the new benchmark.

As shown in Chart 7.2 below, on current trends the transition can be expected to be completed by around 2027-28 (that is in just under 15 years time).

Chart 7.2: Transition to new Age Pension benchmark



Source: National Commission of Audit.

The recommended re-benchmarking of the Age Pension will ensure that Australia's Age Pension programme is more sustainable over the long-term. The proposed transition to the new arrangements will ensure that a person's pension entitlement does not fall in either real or nominal terms.

Recommendation 12: Age Pension – establishing a new benchmark

The Age Pension is an essential part of Australia’s social safety net. The Commission recommends that changes be made to make it more sustainable by:

- a. changing current Age Pension indexation arrangements to a new benchmark of 28 per cent of Average Weekly Earnings and maintaining other price indexation arrangements; and
- b. transitioning to this arrangement, approximately over a 15 year period, by indexing the Age Pension maximum base rate at a rate equal to the higher of the growth in the Consumer Price Index or the Pensioner and Beneficiary Living Cost Index until it is equal to 28 per cent of Average Weekly Earnings.

Eligibility for the Age Pension

As well as suggesting changes to the benchmark arrangements for the Age Pension, the Commission considers that there is a strong case to re-examine other aspects of Australia’s Age Pension system including tightening eligibility requirements to improve its targeting to those unable to support themselves in retirement.

Consistent with the approach outlined above any changes to eligibility should only affect new recipients and even then there should be a reasonably long lead time recognising that people need sufficient notice given the importance of decisions that are often taken ahead of retirement. No existing recipient of the Age Pension will have their eligibility or pension amount reduced as a consequence of any of the Commission’s recommendations in this area.

The potential changes to the Age Pension arrangements outlined below, if agreed by government, would need to be introduced over a significant period of time.

These changes include further adjustments to the Age Pension eligibility age as well as a simplification and strengthening of the Age Pension means test.

The Age Pension eligibility age is currently scheduled to increase to 67 by 2023.

There is a strong case to build on this existing process and establish a formal link between the Age Pension age and improvements in life expectancy. (Further details are outlined in Section 9.1 of the Appendix).

Not only are people now experiencing longer retirements, but changes in the nature of work and improvements to medical technology have meant that many (though not necessarily all) people are also experiencing healthier and more active retirements.

As shown in Table 7.1 below, it is proposed that after the current scheduled increase in eligibility age to 67 in 2023, the Age Pension age be indexed to a proportion of average life expectancy for all persons at age 65.

The proportion used should achieve a steady increase in the Age Pension age, such as increasing by around half a year every five years. The Commission estimates that setting the Age Pension age at 77 per cent of life expectancy at 65 would achieve this outcome and would see the Age Pension age reach 70 years by 2053.

The Commission considers that people born before 1965 should not be subjected to this change or any other further changes to the eligibility age to ensure they have adequate time to plan for their retirement.

Table 7.1: Age Pension age and life expectancy

Year	Proposed Age Pension age	Life Expectancy at age 65	Age Pension age as percentage of life expectancy at 65
2014	65.0	86.0	76%
2019	66.0	86.7	76%
2023	67.0	87.3	77%
2033	68.0	88.5	77%
2043	69.0	89.6	77%
2050	69.5	90.4	77%
2053	70.0	90.7	77%

Source: National Commission of Audit.

Note: The Age Pension age is already increasing under current policy from 65 to 67 by 2023.

The Age Pension could also be better targeted by introducing a simpler single comprehensive means test.

The move to a comprehensive means test could apply from 2027-28, to new recipients of the Age Pension, to allow people sufficient time to adjust to the new arrangements.

A new single comprehensive means test could replace the current arrangement which is underpinned by dual income and assets tests. The existing assets test could be abolished and the income test extended by deeming income from a greater range of assets.

The deeming rates could be based on the returns expected from a portfolio of assets held by a prudent investor. Under this proposal, there would be a single income test based on a combined measure of employment income, business income and deemed income on assets.

Extending deeming could change the means testing arrangements for many assets, including investment properties, holiday homes and the principal residence. The removal of the assets test aims to encourage saving and reduce the complexity from having two tests.

Many older households have saved for their retirement through building equity in their own home. Retirees tend to be income poor but asset rich.

The principal residence is currently exempt under the means test. This allows for high levels of wealth to be sheltered from means testing. The Commission considers that a proportion of the value of the principal residence should be included in the means test, such as the value over a relatively high threshold. The means test would capture the value above \$500,000 for single pensioners and \$750,000 combined for coupled pensioners.

Exempting the principal residence from the means test is inequitable as it allows for high levels of wealth to be sheltered from means testing. For example, under current rules a single person who owns a \$400,000 house and has \$750,000 in shares (\$1.15 million in total assets) would not be eligible for the pension, while a similar person with a principal residence worth \$2 million and \$100,000 in shares (\$2.1 million in total assets) would be able to claim a pension at the full rate.

Financial products exist which allow homeowners to draw down on the value of their home over a period of time. Importantly, these products have legal protections ensuring that no-one can be forced from their homes, even in the event that all equity has been exhausted. A high threshold will mean that there is significant equity that would not be assessed.

With any changes recommended to apply from 2027-28 onwards and only to new recipients of the Age Pension, no current pensioner would be affected by this change. That is, no existing recipient of the Age Pension would have their eligibility or pension amount reduced by the proposed inclusion of the principal residence in the Age Pension means test.

As well as moving to a comprehensive income test, the Commission believes there would be merit in re-examining other aspects of the means testing arrangements.

Current income test parameters can mean that someone with \$47,000 in annual income may still be eligible for some pension under the current income test. Increasing the pension income test withdrawal rate (currently 50 per cent) would reduce the number of people who have significant means from accessing the pension.

In balancing the need to target pensions to those most in need of assistance with the goal of providing incentives for self-provision, the Commission recommends that the income test withdrawal rate for pensions be increased to 75 per cent. This would mean that a single pensioner with private income of around \$32,700 would no longer receive the pension.

Again, in implementing the comprehensive means test and an increase in the withdrawal rate, it is proposed that a no disadvantage test be applied to current recipients. The new rules would apply to people born from 1960 in recognition that significant financial decisions are made by people close to retirement. The group affected is currently aged in their mid 50s and would be expected to reach Age Pension age in 2027.

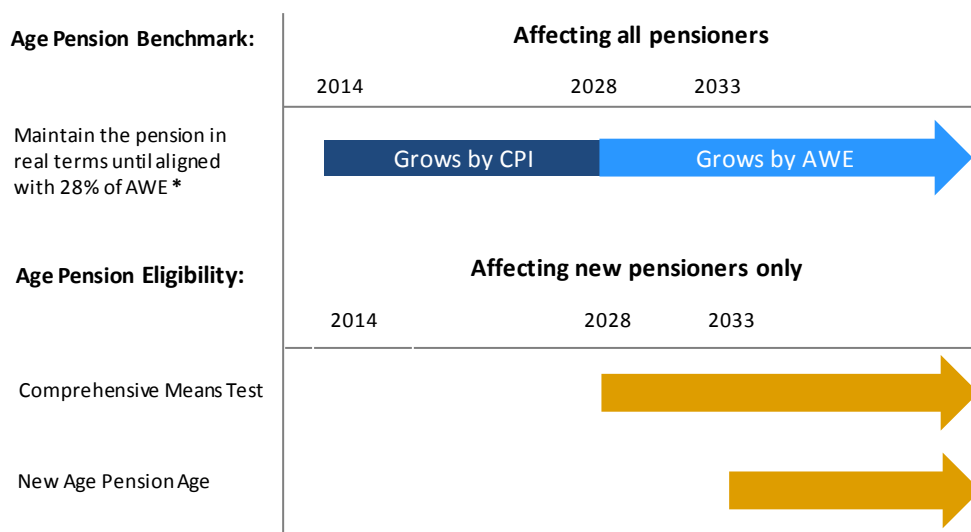
Recommendation 13: Age Pension – tighter targeting of eligibility

The Age Pension is an essential part of Australia’s social safety net. The Commission recommends that changes be made in future to ensure it is more sustainable, affordable and better targeted by:

- a. formally linking the eligibility age of the Age Pension to 77 per cent of life expectancy at age 65 from 2033. This will result in the eligibility age for the Age Pension increasing to around 70 by 2053. The proposed change would not affect anyone born before 1965;
- b. replacing the current income and assets tests with a single comprehensive means test. Under this approach the existing assets test would be abolished with the income test extended by deeming income from a greater range of assets. The new comprehensive means test would apply prospectively to new recipients of the Age Pension from 2027-28 onwards;
- c. including in the new means test the value of the principal residence above a relatively high threshold. The threshold in 2027-28 would be equivalent to the indexed value of a residence valued today at \$750,000 for coupled pensioners and the indexed value of a residence valued today at \$500,000 for a single pensioner. This change would apply prospectively to new recipients of the Age Pension from 2027-28 onwards; and
- d. increasing the income test withdrawal (taper) rate from 50 per cent to 75 per cent. This change would apply prospectively to new recipients of the Age Pension from 2027-28 onwards.

Chart 7.3 below provides an indication of how the recommended reforms to the Age Pension could be introduced over time.

Chart 7.3: Potential phasing of Age Pension reforms



Source: National Commission of Audit.

Note *: The end of the phase-in period for the new benchmark is a projection and will depend on growth in prices and wages

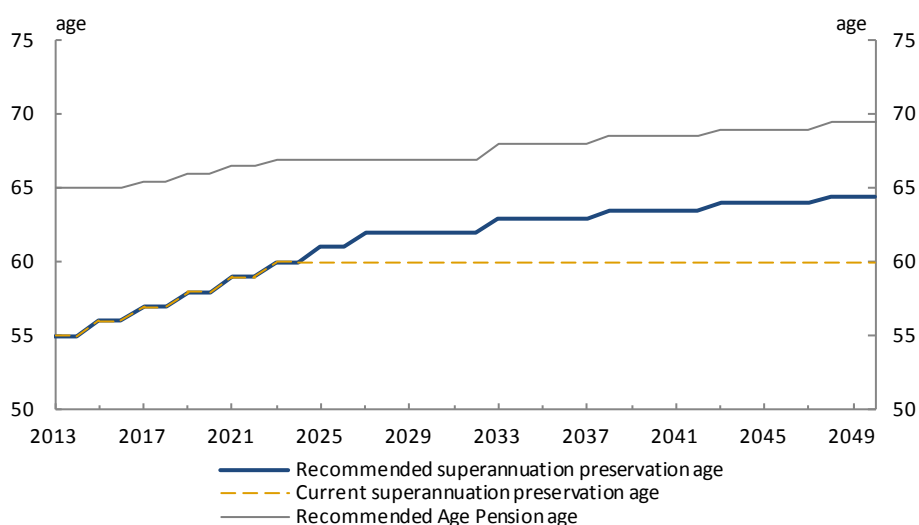
The Age Pension and superannuation are interrelated elements of the retirement income system and should be considered in parallel when changes to one or the other are proposed.

In regard to reform of the broader retirement income system any longer term consideration of superannuation tax concessions would be best considered in the context of the Government’s White Paper on Tax Reform. The Commission notes that many superannuation tax concessions disproportionately benefit higher income earners, when compared to taxation at marginal tax rates under the progressive income tax system.

The Commission has recommended that changes be made to link the Age Pension eligibility age to changes in the life expectancy rates of Australians. Should the Government take up this option, the Commission would recommend that the existing superannuation preservation age should also be increased.

As shown in Chart 7.4 below, the gap between when people can access their superannuation (preservation age) and Age Pension age will shrink over time from 10 to seven years. This is because the current increase in the preservation age to age 60 is phasing at a faster rate than the Age Pension age increase. This gap would widen again from 2033 if the Commission’s recommended changes to the Age Pension age are adopted.

Chart 7.4: Current and recommended preservation age schedules



Source: National Commission of Audit.

It is proposed that the preservation age be increased further to establish and maintain a gap of 5 years between it and the Age Pension eligibility age. This gap should be maintained into the future, including if the Age Pension age should increase further.

Recommendation 14: Superannuation preservation age

The Age Pension and superannuation are interrelated elements of the retirement income system. The Commission recommends some changes be made to the superannuation system to complement changes being recommended for the Age Pension by:

- a. increasing the superannuation preservation age to five years below the Age Pension age;
- b. extending the current phased increase in the preservation age by an extra four years so the preservation age reaches 62 by 2027; and
- c. increasing the preservation age in conjunction with the Commission's proposed increases in the Age Pension age thereafter.

The Commonwealth Seniors Health Card provides cash benefits and a range of concessions to Australians above Age Pension age who do not access a pension. Benefits can include the Seniors Supplement, the Clean Energy Supplement and concessional Pharmaceutical Benefits Scheme medicines. State and local governments and private business may also offer additional concessions.

To be eligible, seniors must also have Adjusted Taxable Incomes below \$50,000 for a single person and \$80,000 combined for couples. Income from tax-free superannuation is not included in the means test.

Approximately 300,000 people currently hold a Commonwealth Seniors Health Card.

The Commonwealth Seniors Health Card could be better targeted to those most in need.

The definition of income used for the Commonwealth Seniors Health Card is Adjusted Taxable Income. This definition of income is a broad measure of means based on taxable income but adds in other means such as fringe benefits.

As the income from tax-free superannuation is not included in Adjusted Taxable Income, the definition of income for the Commonwealth Seniors Health Card omits a major income source of retirees. This can result in inequities as retirees with very large superannuation balances can access government support, leading to differential treatment for people with the same means.

For example, a senior has \$2 million in term deposits and as a result is not eligible for an Age Pension. They earn a return of 4 per cent each year, meaning their Adjusted Taxable Income is \$80,000 and are not eligible for a Commonwealth Seniors Health Card. Alternatively, a person earning the same return but with \$2 million invested in superannuation and \$1 million in term deposits would have an Adjusted Taxable Income of \$40,000 and would therefore be eligible for a Commonwealth Seniors Health Card.

Recommendation 15: The Commonwealth Seniors Health Card

The Commonwealth Seniors Health Card gives senior Australians who do not receive a pension, access to cash payments and concessions and discounts on certain products.

The Commission recommends that the Commonwealth Seniors Health Card be maintained as part of Australia's retirement income system, but that changes be made to improve targeting to those most in need by adding deemed income from tax-free superannuation to the definition of Adjusted Taxable Income used for determining eligibility for the Commonwealth Seniors Health Card.

7.2 The National Disability Insurance Scheme

The National Disability Insurance Scheme (NDIS) is a new Commonwealth programme intended to provide ‘reasonable and necessary’ long-term care and support, but not income support, to people with a permanent physical or mental impairment.

It has broad community and bi-partisan political support and is intended to replace and expand on existing disability services, which the Productivity Commission described as being ‘...underfunded, unfair, fragmented, and inefficient’.

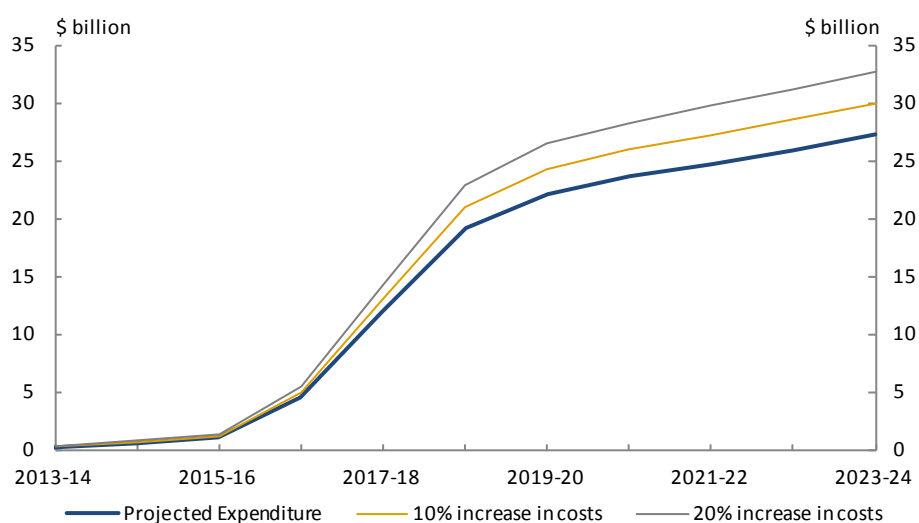
The NDIS is intended to correct for these deficiencies and provide Australians with disability funding to deliver support tailored to their needs including specialist equipment and respite care.

A separate smaller but related scheme, the National Injury Insurance Scheme, is also to be established, in conjunction with the States, to provide lifetime care for people suffering a catastrophic injury, for example through motor vehicle, workplace or general accidents.

The NDIS commenced on 1 July 2013. The initial roll-out is limited to a small number of locations in New South Wales, Victoria, South Australia and Tasmania. The scheme is expected to be fully rolled out by 1 July 2019.

When fully implemented in 2019-20 the NDIS is expected to benefit approximately 450,000 Australians with disability and will have a total annual cost of \$22.1 billion. As most of the costs of the scheme are participant driven, any unanticipated increase in participant numbers or package costs will have a substantial impact on total expenditure.

Chart 7.5: Projected Commonwealth and States’ spending on the National Disability Insurance Scheme



Source: Department of Finance and the National Commission of Audit.

Indications from the early operations of the scheme suggest that the average package cost is around \$46,000 per participant per year, compared with an estimated average cost of

\$35,000 per participant per year that was factored into the initial design and costing of the scheme.

The NDIS represents a major new area of Commonwealth spending responsibility, which is yet to be fully implemented. It is a worthy scheme with widespread community support. There are, however, significant financial risks associated with the introduction of the scheme. The Commonwealth is bearing the majority of the risk of any cost overruns. In negotiations with States the Commonwealth agreed to meet all extra costs during its launch and transition and at least 75 per cent of cost overruns of the mature scheme.

The Commission considers that the NDIS should continue to be supported but it should be implemented in a way which is fiscally responsible and minimises risks of higher than expected spending. This can be achieved by exercising budget control to ensure the long-term sustainability of the NDIS.

A number of features of the scheme may unnecessarily inhibit the flexibility of the NDIS Board and National Disability Insurance Agency to deliver on outcomes, including the requirement for the States to agree changes to certain scheme rules and the provision of in-kind payments.

The scheduled roll-out of the NDIS is highly ambitious. This increases the risk of inadequate delivery of disability services to participants and also poses significant financial risks to the scheme as a whole. The current schedule anticipates that the system will be able to satisfactorily cope with an increase in the number of people covered by the scheme from 30,000 in 2015-16 to 450,000 in 2018-19.

Risks associated with this compressed roll-out schedule include: workforce shortages and increased labour costs; service delivery quality control and capacity constraints; and IT development and infrastructure delays. This already challenging scenario is further complicated by uncertainties associated with expected client numbers and package costs.

The Commission considers that there would be merit in pursuing a slower roll-out schedule to help minimise the risks associated with the introduction of the scheme. An extended phasing in of the scheme would need to be re-negotiated with the States. The current bilateral arrangements with each participating State are closely aligned with NDIS funding arrangements.

Aside from managing financial risks, a roll-out over an extended period would allow lessons learned from the early results (for example around expected average package costs) to be incorporated into the scheme's design.

The governance arrangements for the NDIS have significant complexity and involve multiple layers of responsibility, including the NDIS Board, the National Disability Insurance Agency, the Advisory Council, the Commonwealth Minister, the COAG Disability Reform Council and the Joint Select Committee of the Commonwealth Parliament.

Each of these bodies has its own requirements for reports, briefings and information from the National Disability Insurance Agency. This imposes an ongoing demand on the agency and is an issue which needs to be addressed.

Neither the Commonwealth Government as the major funder, nor the State governments as contributory funders, have control of this major initiative, but they collectively have political responsibility for the success of the scheme.

When the NDIS is fully rolled out, annual expenditure is forecast to exceed \$25 billion. The Commission considers that the accountability for this level of funding is too great a responsibility for an independent board. It considers that the governance arrangements for the NDIS need to be strengthened.

This can be achieved by making the National Disability Insurance Agency a prescribed statutory agency under the *Financial Management and Accountability Act 1997*. It would be a standalone agency with a Chief Executive Officer reporting directly to the Commonwealth Minister.

Under this arrangement, the existing Board and Advisory Council could be consolidated to become a single advisory committee.

The Commission's suggested changes to the governance arrangements would have no impact on eligibility for the scheme or the proposed financial contributions of the Commonwealth and the States. The COAG Ministerial Council would be retained, recognising the significant financial contribution being made by the States to the NDIS.

The proposed changes would however, bring a clearer focus on the responsibilities of the Minister and the National Disability Insurance Agency, and in particular, on ensuring the financial sustainability of the scheme. This is particularly important from the Commonwealth's perspective given it has agreed to meet 100 per cent of cost overruns during the launch and transition phases.

Disability service systems in different States vary significantly in their capacity, their structure (particularly in regard to the level of involvement and maturity of not-for-profit providers) and their relationship with clients (with some States well advanced towards the individualised choice and control model that is intended to be the hallmark of the NDIS). The National Disability Insurance Agency will need to take these differences into account when implementing the scheme across Australia.

One of the advantages of having a range of service delivery options is the ability to identify best practice which could be applied in other jurisdictions.

The Commission notes that the National Disability Insurance Agency is currently recruiting staff in a range of different areas. During this phase, the Agency should seek to contract out functions, where possible, to the informal sector and other organisations already working in disability services. Such an approach would also allow it to leverage the experience of existing State disability services, where these are currently being provided in an efficient and effective manner.

Aside from the potential to realise cost savings through such a contracting arrangement, it is a good way of better integrating the informal care sector into the NDIS arrangements. The Commission is aware that such approaches have already been used in NDIS launch sites.

The outsourcing of the National Disability Insurance Agency assessment function may create risks relating to the financial sustainability of the NDIS or conflicts of interest for organisations which undertake assessment and also provide services to NDIS participants. Further analysis of this issue should be undertaken by the National Disability Insurance Agency to determine if these risks can be properly mitigated and managed in an outsourced arrangement, bearing in mind that experience with other government contracting arrangements has shown that they can be mitigated by good contract design and management.

The Commission notes that the National Injury Insurance Scheme is currently being implemented as agreed between the Commonwealth and States. This will provide no-fault insurance coverage for all victims of catastrophic injury resulting from motor vehicle, workplace, medical and other accidents. The National Injury Insurance Scheme will be funded by additional premiums on top of relevant insurance policies.

Moreover, the National Injury Insurance Scheme seeks to standardise arrangements across all States. Its implementation is a critical part of the NDIS scheme design, as it helps to constrain the costs of the NDIS (otherwise, victims of these accidents would be covered by the NDIS).

There is a risk that any slippage or non-compliance with the agreement to implement the National Injury Insurance Scheme will shift costs to the NDIS. The Commission suggests that the Commonwealth continue to work with the States to deliver the National Injury Insurance Scheme in full and consistent with the agreed timetable.

Recommendation 16: The National Disability Insurance Scheme

The National Disability Insurance Scheme is a worthy scheme with widespread community support. The Commission recommends the Commonwealth continue to support the introduction of the National Disability Insurance Scheme, but that the scheme be implemented in a way which is fiscally sustainable by:

- a. pursuing a slower phasing in of the scheme recognising that this will require the re-negotiation of bilateral agreements with the States;
- b. amending governance arrangements to make the National Disability Insurance Agency a prescribed agency under the *Financial Management and Accountability Act 1997*, with the Chief Executive Officer directly accountable to the Minister;
- c. exercising budget control to ensure long-term financial viability;
- d. implementing contracting arrangements with the informal (not-for-profit) sector or other disability services bodies, including those operating in existing State schemes, to ensure contestability in the delivery of services to people with disabilities; and
- e. simplifying reporting arrangements to ensure transparency in the cost and efficiency of the delivery of disability services between the States.

7.3 A pathway to reforming health care

Health is an issue of great importance to all Australians. Our current health system has many strengths — including highly trained and dedicated doctors and nurses — and produces excellent health outcomes for most of us.

But the nature of health care is highly complex, illnesses arrive randomly and can often entail significant expense. There are enormous knowledge and informational imbalances and it is a reality that sick people often feel vulnerable. Given this, governments have an essential role to play.

The Commission considers that in a civilised, affluent and modern country like ours, universal health coverage is absolutely necessary for everyone.

The combination of demographic trends, income growth and new technologies mean that demand for health care in Australia will increase strongly. The reality is older people tend to use more health care services and the increasing population of older Australians will raise health care costs.

Recent Productivity Commission projections suggest Commonwealth Government spending on health will rise from around 4 per cent of GDP in 2011-12 to 7 per cent in 2059-60. Health expenditure by State governments is projected to rise from around 2.5 per cent of GDP to almost 4 per cent of GDP over the same period. Other research projects similar trends.

Health care spending represents the Commonwealth's single largest long-run fiscal challenge, with expenditure on all major health programmes expected to grow strongly to 2023-24 and beyond (Chart 7.6). At a practical level, increased health spending reduces resources for other key areas.

Australia's health system is not equipped to face these future challenges and a universal health scheme is unlikely to be sustained without reform. We need to make the system we have work better.

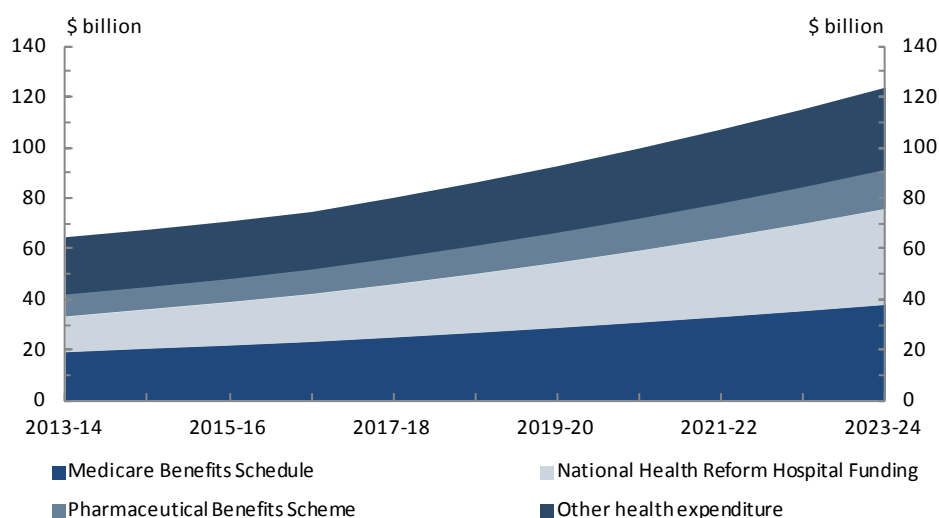
Putting health care on a sustainable footing will require reforms to make the system more efficient and competitive. The supply of health services must increase in line with growth in demand and improvements in productivity are a natural way of ensuring this. More deregulated and competitive markets, with appropriate safeguards, have the greatest potential to improve the sector's competitiveness and productivity.

Also, in a system like ours, the community must become more aware of the real costs of health care.

As with much of the Commission's report, there are no instant or easy solutions to the challenges of health care. But we should be prepared to take steps now to begin

strengthening the health system, otherwise more difficult and painful reforms will be needed later.

Chart 7.6: Projected growth in Commonwealth health spending



Source: National Commission of Audit.

The Commission has separately examined the Pharmaceutical Benefits Scheme (Section 7.4), the structure of the Health Portfolio (Section 9.1) and mental health (Section 8.6).

In relation to the overall health care system, the approach taken by the Commission is to outline a two-stage process for reform.

The first stage consists of a number of incremental changes that could be introduced relatively quickly to improve the system’s short-term viability. More important, they would provide necessary foundations for larger structural reforms.

The second stage will require detailed consideration of opportunities to restructure the health system for the long-term. The inherent complexities of the sector and its risks and uncertainties must be acknowledged as should the fact that health care is a shared responsibility across the Commonwealth and State governments.

A framework for reforming funding arrangements could consider: policy interventions aimed at restraining expenditure; policies aimed at improving the efficiency of expenditure; and policies aimed at more fundamentally changing the incentives for users, providers and governments. The Minister for Health should take this forward.

These reforms are not just about reducing costs. They also aim to increase efficiency, provide consumers with more power in selecting who arranges their health services, provide better quality care for those with chronic conditions and build a fairer health system for all Australians.

Short to medium-term reforms

In suggesting a number of reforms to the health system, the Commission is guided by the principles outlined in Chapter One, including the need to protect the truly disadvantaged, respect personal responsibility and choice, reduce complexity, ensure value for money and be open to the use of markets and contestability in the provision of services.

The suggested reforms fall into five categories:

1. Requiring those on higher incomes to take greater responsibility for their own health care needs.
2. Requiring everyone to make a small contribution to the costs of their own health care.
3. Improving the effectiveness of private health insurance arrangements.
4. Improving the effectiveness of Medicare.
5. Improving arrangements with the States.

People on higher incomes should take greater individual responsibility for the cost of their health care. They are better placed to take out private health insurance and should be required to do so.

Expanded private health insurance coverage should be introduced for basic health services currently covered by Medicare. Higher-income earners should be required to insure for basic health services in place of Medicare.

Expanded private health insurance plans would, at a minimum, cover all services provided by Medicare and public hospitals and would have to pay for all health care expenses of the insured, including the cost of treatment in a public hospital.

This requirement on higher income earners to take greater responsibility for their health care could be put into effect through a penalty arrangement that would result in an increase in the Medicare Levy surcharge for people on high incomes who do not purchase expanded private health insurance coverage.

The threshold for purchasing expanded cover should be set at \$88,000 for singles and \$176,000 for families. A Medicare Levy surcharge of 1 to 1.5 per cent already exists and this should be increased to between 3 and 3.5 per cent as part of this reform in order to encourage the switch to private health insurance (see Table 7.2).

Table 7.2: Proposed Medicare Levy Surcharges

	Base Tier	Tier 1	Tier 2	Tier 3
Singles	Less than \$88,000	\$88,000 - \$102,000	\$102,000 - \$136,000	\$136,000 +
Families	Less than \$176,000	\$176,000 - \$204,000	\$204,000 - \$272,000	\$272,000 +
Current	0.00%	1.00%	1.25%	1.50%
Proposed	0.00%	3.00%	3.25%	3.50%

Source: National Commission of Audit.

The majority of Australians would be unaffected by this change and would carry on with Medicare as now.

The Commission has considered the arrangements for the private health insurance rebate which, alongside lifetime health cover and the Medicare Levy surcharge, forms part of the range of incentives to stimulate the take-up of private health insurance.

There is currently an income-tested rebate to help people meet the cost of health insurance (currently set at up to 30 per cent for people under the age of 65). The size of the rebate varies with age and is currently means tested. In addition, the lifetime health cover loading allows health funds to vary the premiums paid by individuals above 30 years of age according to their age of entry into the fund.

The Government has undertaken to remove means testing of the rebate.

Given the Commission's proposal to make it mandatory for high income earners to take out private health insurance, it is not necessary for these people to have access to the Private Health Insurance Rebate.

The Commission recognises, however, that making private health insurance mandatory for higher income groups may have consequences for the operation of the health insurance market including people's responsiveness to price changes. This may impede the development of a more competitive health insurance market.

However, further analysis should be undertaken to examine the interaction between the surcharge, the rebate, lifetime cover and the extent of eligible insurance coverage as part of a more fundamental review of the health care system.

As well as those on higher incomes, the Commission considers it is important that steps are taken to provide a signal to people about the consequences of the use of the health care system.

This should begin with a proposal for all consumers to make a small contribution towards the cost of their health care through a co-payment for all items listed on the Medicare Benefits Schedule.

Co-payments send a clear price signal to all consumers that medical services come at a cost, which may reduce demand for unnecessary or overused services. The co-payment could be based on a matrix pricing structure, similar to arrangements in place for the Pharmaceutical Benefits Scheme.

Co-payments would be underpinned by a simple means test based on concession status and complemented by a strengthened safety net arrangement. To protect the less well off and the chronically ill from excessive out of pocket costs, the safety net would take effect when a patient exceeds 15 visits over the course of a year. Once a patient exceeds the safety net threshold the co-payment would reduce by 50 per cent.

The Commission proposes the introduction of co-payment arrangements as illustrated in Table 7.3 below. These co-payments would be in addition to any existing out-of-pocket costs.

Table 7.3: Co-payment rates for general patients and concession card holders

	Below safety net threshold	Above safety net threshold
General patients	\$15.00	\$7.50
Concession card holders	\$5.00	\$2.50

Source: National Commission of Audit.

By introducing co-payments for services that are currently covered by bulk billing there is a risk of cost shifting, as some patients may seek out free treatment in the emergency room of public hospitals for services that would more appropriately be treated by a general practitioner. To address this issue, State governments should consider introducing equivalent co-payments for certain emergency room settings.

A possible co-payment structure for emergency rooms could be based on the hospital triage categorisation system. Emergency room patients are currently triaged on the basis of the speed with which they need medical attention. Triage categories one, two and three relate to patients who present with critical, life-threatening or potentially life threatening conditions. Co-payment arrangements would not apply in these cases.

Triage categories four and five relate to less urgent conditions that in many cases could be more effectively treated in a General Practitioner setting. State governments could consider introducing co-payments for triage categories four and five, at levels higher than those proposed for out-of-hospital services.

A payment structure along these lines would retain free emergency room care for those in genuine need while providing price signals that direct patients to access the most cost effective treatment setting.

There would also be a need to ensure that the co-payment provides a price signal as actually intended. In this light, consumers would not be able to insure against the co-payment. Similarly, medical practitioners who wish to bulk bill should not be able to waive the co-payment. The Government will need to ensure the co-operation and compliance of insurers and doctors in the implementation of these arrangements.

While the Commission supports the retention of safety net arrangements, there is scope to ensure they assist those in greatest need.

The Medicare Safety Nets provide financial assistance for out of hospital medical services. There are two distinct safety nets in operation:

- the *original Medicare Safety Net* which was introduced at the same time as Medicare in 1984; and
- the *Extended Medicare Safety Net* which was introduced in 2004 and provides an additional rebate for Australian families and singles who incur out-of-pocket costs for Medicare eligible non-hospital services.

The extended safety net is not meeting its objectives. In 2009 a review showed 20 per cent of Australians living in the wealthiest areas received 55 per cent of extended safety net benefits, while the 20 per cent living in the poorest areas received less than 4 per cent of benefits.

The Commission considers safety nets should be targeted to protect the truly disadvantaged and not directed towards people who can afford to make an appropriate contribution to the cost of their health care. To this end the Extended Medicare Safety Nets should be increased from \$2,000 to \$4,000. However, the Concessional Extended Medicare Safety Net threshold should be maintained at the existing levels.

The Medicare Benefits Schedule is large and complicated. In its current form it is 892 pages long with items ranging from medical, nursing and allied health services to pathology and imaging services. Of its nearly 6,000 items (excluding pharmaceuticals) as of 2012, only 3 per cent had been formally assessed against contemporary evidence of safety, clinical effectiveness and cost-effectiveness.

There would be merit in a review or ongoing reviews of the schedule to identify and remove ineffective items.

Opportunities exist to improve the operation of Australia's private health insurance system. Almost half of all Australians have private health insurance and as long as there are

appropriate incentives in place the industry could play a constructive role in driving efficiency in the health care sector.

Health insurers whose members receive the best and most efficient health care should win more business. Likewise, their operating model is more likely to succeed if they are able to deliver health care that keeps their members out of hospital.

If the health funds are to drive greater efficiency they will need to change from passive players into genuine health care partners that support their members to navigate the health system and assist them to better manage chronic conditions.

This transformation will require changes to the rules that govern the private health insurance industry including risk equalisation and price setting arrangements.

Risk equalisation is a scheme that supports community rating (effectively a cross subsidy arrangement), whereby individual users cannot be made to pay more for private health insurance based on age or illness. To ensure particular funds do not struggle financially because they have to insure larger numbers of unhealthy members, claims are redistributed around the industry to equalise the risk. This is, in effect, a reinsurance scheme.

These payments are based on actual costs paid out by particular funds, meaning the more a fund disburses in payments to members, the more it receives through the reinsurance scheme from other funds. This arrangement reduces incentives for insurers to invest in cost-effective disease management because the losses from high cost customers are shared across the industry, rather than borne by the individual health fund.

The Commission considers a system of prospective risk adjusted payments warrants consideration. Under this system payments between insurers are based on the risk characteristics of their members, rather than actual expenses.

This would provide stronger financial incentives for insurers to invest in improving the health of their members, as savings from preventative care and more cost-effective management of chronic conditions would flow to the insurer rather than being shared across the industry. Further details are contained in Section 9.3 of the Appendix to this report.

The current rules also prevent private health insurers from covering primary care settings, including medical items and services provided through the Medicare Benefits Schedule. This limits the health funds' ability to assist in improving the health outcomes of the elderly and chronically ill at the point of diagnosis, which is usually when they initially visit their local doctor.

In many cases health funds are not made aware of when their members develop medical conditions and find out only after the member has been treated in a hospital and seeks reimbursement from the fund. Allowing health funds to cover primary care settings would

make it possible for them to be more aware of members' health risks. Funds could assist members to manage chronic conditions in out-of-hospital settings. This change is also needed to underpin the requirement for higher-income Australians to take out private health insurance.

The Commission acknowledges private health insurance can only play a greater role in driving greater efficiency if it remains affordable for the majority of Australians.

The Minister for Health now decides whether or not to allow annual premium increases based on each fund's cost structure.

If a fund attempted to reduce administrative costs, the resulting savings would be factored into the Minister's next assessment, leaving it no better off and removing incentives for efficiencies. The end result is higher premiums for all members.

Accordingly, the Commission considers the current price setting mechanism should be replaced with a price monitoring arrangement. As outlined in Section 9.1, the Commission proposes that the Private Health Insurance Administration Council be merged with certain other health agencies into a proposed new Health Productivity and Performance Commission.

For some people, particularly smokers, poor health is a result of lifestyle choices. Lifestyle related conditions impose a significant and growing cost on the health system which are mostly borne by third parties, including health funds, tax payers and other users, rather than the individuals responsible.

The community rating of health insurance products means unhealthy lifestyle choices made by some forces up premiums for all. In other segments of the insurance market, risk factors such as smoking are taken into account when calculating premiums. This principle should be applied to health insurance.

The Commission considers more incentives should be used to reward those who make lifestyle decisions that reduce their risk of poor health. To this end, consideration should be given to relaxing rules relating to 'improper discrimination' that prevent health funds from charging different prices based on a person's individual characteristics. Instead, health funds should be allowed to vary premiums for a limited number of lifestyle factors, including smoking, which materially increase a person's health risk.

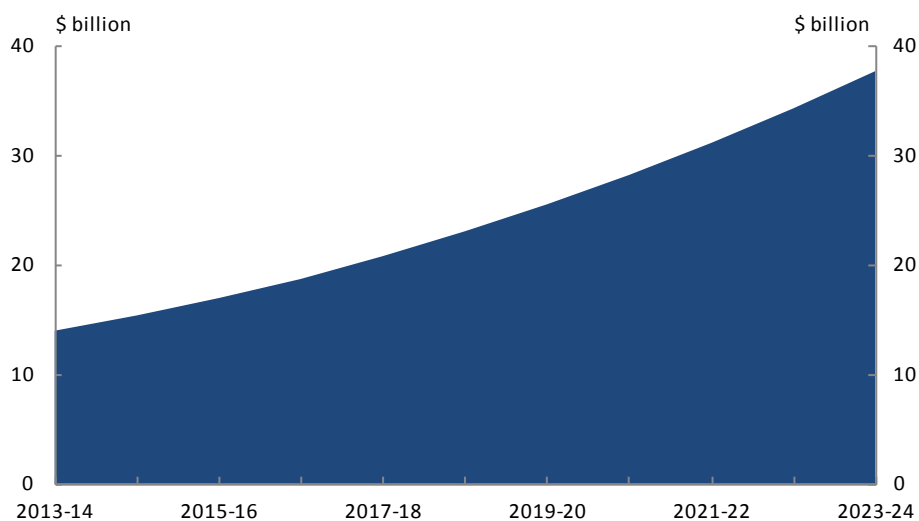
While responsibility for funding and regulating the health system is largely shared between the Commonwealth and States, their respective roles are not always clear leaving room for duplication and waste.

Hospital funding is a strongly growing area of Commonwealth health expenditure (Chart 7.7), largely driven by the commitment under the National Health Reform Agreement

to fund 45 per cent of the efficient growth in the cost of public hospital services from 2014-15 to 2016-17 and 50 per cent from 2017-18 onwards.

Efficient growth is determined by the work of the Independent Hospital Pricing Authority, which sets the national efficient price and the national efficient cost of public hospital funding. These are major determinants of the level of Commonwealth Government funding for public hospital services. (The Commission recommends that this Authority be subsumed into a proposed Health Productivity and Performance Commission, as outlined in Section 9.1 below.)

Chart 7.7: Projected Commonwealth spending on hospitals



Source: National Commission of Audit.

Under the current National Health Reform Agreement between the Commonwealth and States, both jurisdictions are jointly responsible for funding public hospital services. Management of the systems is the responsibility of the States.

The Commission considers that the provision of public hospital services should remain the responsibility of the States for now. Given this, hospital funding should be considered in the context of addressing vertical fiscal imbalance.

The broader reforms recommended by the Commission to address the degree of vertical fiscal imbalance through a closer matching of revenue-raising capacity with expenditure responsibilities could result in greater flexibility to the States to deliver services such as public hospitals.

In these circumstances, an opportunity would exist to renegotiate current health funding commitments with the States.

In the meantime, the Commission considers the Commonwealth could limit its funding contribution to public hospital services to 45 per cent of the efficient growth in this cost.

A number of submissions to the Commission noted that the National Health Reform process is currently seen as unnecessarily complex and inefficient. This includes overly burdensome reporting requirements that consist of an overarching objective, seven long-term objectives, 11 outcomes, 26 progress measures, 15 outputs and 70 performance indicators. There are also seven performance benchmarks.

As highlighted in Chapter Six of this report, there is a need for a better balance between appropriate levels of reporting between the Commonwealth and States while ensuring the necessary accountabilities.

Although reporting on key data is essential, less Commonwealth involvement would reduce duplication and reporting costs.

However, as long as the activity based funding arrangements for public hospitals remain in operation, it will be necessary for the Independent Hospital Pricing Authority to continue to receive data needed for establishing national efficient price and the national efficient cost estimates. The Commission's proposals for including the Independent Hospital Pricing Authority in a new Health Productivity and Performance Commission may help address this issue and are further outlined in Chapter Nine.

In seeking to boost the supply of health care services to meet an expected rise in demand it will be important to increase the number of health professionals and examine the scope of practice of some of them. This includes reassessing the appropriate skills mix needed for particular treatments.

Australia's arrangements for the scope of professional practices and the appropriate skills mix for health professionals are less flexible than in other countries. Many health professionals report less qualified staff could safely undertake a significant share of their work.

Health Workforce Australia has initiated an Expanded Scope of Practice programme aimed at redesigning roles of the health workforce to improve productivity, retention, efficiency and effectiveness of health care services. This reform can go further.

In particular, pharmacists and nurse practitioners could, in an expanded range of settings, provide immunisations, monitor blood pressure and diabetes tests, issue medical certificates for certain conditions (such as colds or hay fever) and undertake some prescribing for chronic conditions following an initial diagnosis and prescription by a doctor.

As noted above, older people tend to consume more health care than others, reflecting their higher incidence of disease and the complexities of managing chronic health conditions that often occur later in life. These trends compound among the very old.

About one in four patients at the end-of-life are unable to make their own health care decisions. This is a growing concern as more Australians live longer but with increasing dependence on health care before the end-of-life.

There are opportunities for more individuals to provide instructions regarding their future health care preferences. Australians 18 years of age and over can put in place an Advance Care Directive - also referred to as a living will. These documents specify preferences for future medical, surgical, dental and other health care if a person is unable to make reasonable judgements about required treatment.

The use of directives is also a feature of many age care packages and will cover, for example, all home care packages through the introduction of Consumer Directed Care directives from July 2015. An opportunity exists to allow and encourage individuals to plan for their future medical treatment as well as their aged care preferences through a broader integrated care directive.

Recommendation 17: Short to medium-term health care reforms

Australia's health system is not well equipped to face future challenges such as an ageing population and rising health services costs. The Commission recommends the Commonwealth Government pursue reforms to improve the health system as soon as practicable including:

- a. requiring higher-income earners to take out private health insurance for basic health services in place of Medicare; and precluding them from accessing the private health insurance rebate;
- b. the introduction of co-payments for all Medicare funded services, underpinned by a new safety net arrangement that would operate once a patient has exceeded 15 visits or services in a year. General patients would pay \$15.00 per service up to the safety net threshold and \$7.50 per service once the safety net threshold has been exceeded. Concession card holders would pay \$5.00 per service up to the safety net threshold and \$2.50 per service once the safety net threshold has been exceeded;
- c. implement arrangements to ensure that consumers are not able to insure against the co-payment and that medical practitioners who wish to bulk bill are not able to waive the co-payment;
- d. encouraging the States to introduce a co-payment structure for public hospital emergency departments for less urgent conditions that could be appropriately treated in a general practice setting;
- e. increasing the threshold for the General Extended Medicare Safety Net to \$4,000, while maintaining the Concessional Extended Medicare Safety Net threshold at

existing levels. Safety net arrangements for Medicare and the Pharmaceutical Benefits Scheme should be retained to ensure support for people facing significant hardship, albeit with some adjustments;

- f. reviewing the Medicare Benefits Schedule to identify and remove ineffective items, replace expensive items with less expensive alternatives where available and investigate options for cost recovery for applications to list items on the Schedule;
- g. reforming the private health insurance market to provide greater incentives for efficient and cost effective health management through deregulating price setting arrangements, allowing health funds to expand their coverage to primary care settings, relaxing community-rating to allow health funds to vary premiums to account for a limited number of lifestyle factors, including smoking; and reforming the arrangements by which insurers equalise risks through the sector;
- h. limiting the Commonwealth's contribution to efficient growth in the cost of public hospital services to 45 per cent applying from 2014-15 and — with the exception of activity based funding — reducing the health reporting requirements significantly that the Commonwealth places on the States; and
- i. extending the current scope of health professional practices (for example, pharmacists and nurse practitioners) to address the future needs of Australia's health care system.

The pathway to longer-term reform of the health system

The Terms of Reference ask the Commission to look at whether there is a strong case for continued direct involvement in activities currently undertaken by government. The options outlined above go part of the way to addressing this issue in the area of health.

However, the Commission considers detailed work is necessary to delve more deeply into restructuring the health system. This recognises both the complexity and the need to progress reform carefully – either through major structural reform or incremental change.

Whichever approach is pursued there are two fundamental questions, who pays for health care and who provides health services?

The answers have substantial flow-on impacts on how the Commonwealth delivers and influences existing health programmes, such as the Medicare Benefits Schedule, private health insurance and hospital funding.

The report of the National Health and Hospitals Reform Commission highlighted many of the issues around strengthening and improving Australia's health system and suggested the case for health reform is compelling.

In considering health care reform the Commission is conscious of the fact that people with chronic health issues need the best support. They should not be bounced from doctor to doctor. Australia should move toward a more integrated health services system where people are looked after on a 'whole of life' not 'episode by episode' basis.

To move the system in this direction the Minister for Health should develop an approach to put Australia's health system on a more sustainable footing – one that contains costs while preserving and improving access to quality health care.

This is a complex and detailed undertaking but it cannot be avoided.

In undertaking it the Minister should identify a framework that brings together all aspects of the health system - public and private, hospital and community based - to support the organisation and delivery of health care in a way that tightly focuses on individuals.

The framework should aim for simplicity. The right incentives need to be in place to align health services with the requirements of individual Australians. It must make constructive use of the contribution of private health insurance and private hospitals.

One option (although it is only an option) is a universal health insurance arrangement.

This would make health insurance mandatory for all Australians. The Commonwealth would pay premiums for low income and high risk groups. The government would also pay for the health insurance of all children. It would be compulsory for people on higher incomes to take out private health insurance.

Medicare would remain as the default insurer for those on lower incomes, with their premiums paid by government direct to Medicare. People on low incomes could alternatively choose a private health insurer, with their premiums still paid by the government.

One possible advantage of this approach is that over time Commonwealth funding for Medicare, hospitals and the private health insurance rebate could be redirected into a single pool that subsidised the health insurance needs of lower income Australians and those in high risk groups, including people with chronic health needs. In this sense funding would follow the patient.

The capacity for such an arrangement to inject greater competition and therefore efficiencies into the Australian health care system over the longer term should not be underestimated.

Whether this approach is preferred over alternatives would be a matter for government but the Commission considers it should be considered as one of the possibilities for reforming Australia's health care system.

Recommendation 18: A pathway to reforming health care

Detailed work is required to examine opportunities to improve the efficiency and effectiveness of Australia's health care system over the medium to longer term. The Commission recommends the Minister for Health be tasked with developing options to reform Australia's system of health care.

The Minister should report to the Prime Minister in 12 months' time on progress and a preferred way forward.

7.4 The Pharmaceutical Benefits Scheme

The Pharmaceutical Benefits Scheme is an integral part of the health system in Australia, providing consumers with affordable and timely access to over 857 medicines. These medicines are available to all Australians regardless of location at a universal and accessible price.

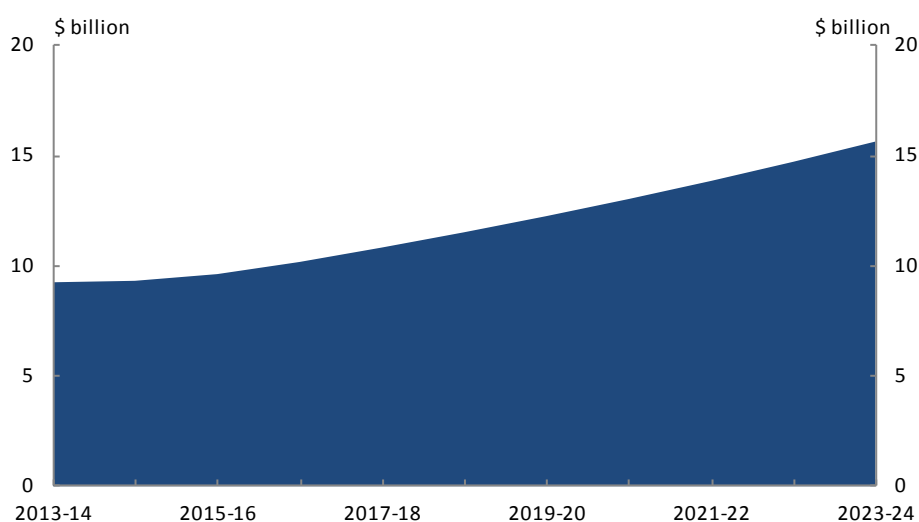
The rationale for governments subsidising medicines through the Pharmaceutical Benefits Scheme remains strong. By ensuring that medicines are affordable and widely available, consumers are more likely to make decisions on medicine usage based on medical need rather than cost, leading to improved health outcomes.

The benefits flow not only to the individual but also to the community at large through lower demand for more costly acute care interventions in hospitals as well as to better workforce participation from having healthy workers.

A key rationale is that the government is able to bargain more effectively on behalf of consumers with large multinational suppliers for new patented medications. It can also use its single buyer status to tender for generic medicines at more favourable prices. Another reason for intervention is that those with the highest medical need often have the least capacity to purchase medicines.

Government spending on pharmaceuticals has risen substantially since the scheme was introduced and has more than doubled in the last 10 years alone. It has historically been one of the fastest growing areas of government expenditure and is expected to be so in the medium to longer term, as highlighted in Chart 7.8 below.

Chart 7.8: Projected spending on the Pharmaceutical Benefits Scheme



Source: National Commission of Audit.

This largely reflects the combination of the ageing of the population, the increasing incidence of chronic conditions, the listing of new and relatively expensive medicines on the PBS schedule and growing demand for pharmaceutical products. It is estimated that Australians aged over 65 accounted for almost two thirds of the number of Pharmaceutical Benefits Scheme medicine prescriptions filled and around half of all of the scheme's expenditures.

In recent years cost containment in the Pharmaceutical Benefits Scheme has been achieved most notably through improved price disclosure arrangements, resulting in a slowing in the real rate of the scheme's growth over the forward estimates to 1.4 per cent. However, this expenditure growth does not include potential new listings which have historically been a major contributor to growth.

Reductions in Australian medicine prices often lag behind those of many other advanced countries. For example in the case of Atorvastatin, currently the most highly prescribed and highest cost to government medicine in Australia, New Zealand pays \$2.01 in comparison to the price paid in Australia of \$38.69.

To manage expenditure growth in the Pharmaceutical Benefits Scheme, the Commission considers that major reform of the funding arrangements and management of the scheme, together with reforms to the community pharmacy sector are needed.

In particular, the Commission considers that there is a need to take a holistic approach to managing Pharmaceutical Benefits Scheme medicine listings and price negotiations.

More needs to be done to 'create room' for new medicine listings by rationalising existing listings or re-negotiating new prices. Under current arrangements, once a medicine is recommended by the Pharmaceutical Benefits Advisory Committee, there are expectations that the Commonwealth Government will list it.

Little consideration is given to whether this can be afforded or what else can be done to accommodate the new listing, for example by de-listing existing medicines, reducing the prices of existing listings through tenders, negotiating bundled packages with manufacturers and/or working within a pre-negotiated annual budget.

One approach to reducing cost pressures on the Pharmaceutical Benefits Scheme would be to either freeze expenditure at the current level or set a predetermined funding envelope over a period of perhaps seven years.

However, to ensure that the funding envelope keeps pace with community expectations, demographic change and developments in pharmacy technology, there should be an independent review before the conclusion of the initial seven year period and recommendations put to government about the appropriate size of the next funding envelope.

Under this arrangement, any new pharmaceuticals would be listed only if existing drugs are removed from the Scheme, or better prices are negotiated for pharmaceuticals currently listed. This would be accompanied by a strengthening of negotiation arrangements with manufacturers and pharmacies.

Related to this, an independent authority (the 'PBS Entity') would be established and headed by a Chief Executive Officer reporting to the Minister. The PBS Entity would manage access to subsidised pharmaceuticals and operate under a clear objective to provide reliable and affordable access to a wide range of necessary pharmaceuticals within the defined budget.

To meet this objective, the PBS Entity would: manage the funding of new and currently listed medicines; negotiate prices for existing drugs; and make decisions about de-listing drugs. This would require the PBS Entity to negotiate directly with pharmaceutical companies and with pharmacists in relation to the margins and dispensing fees charged by pharmacies. It is anticipated that this process would lead to further price falls for pharmaceuticals.

The PBS Entity would be accountable for the whole of PBS performance, including the rationalisation of the current multi-stage decision-making process for pharmaceutical listing and pricing issues.

A mechanism would exist to permit the government to have items added to the PBS list in exceptional circumstances by introducing a disallowable instrument into Parliament. The process would require receipt of advice from the PBS Entity regarding which items are to be de-listed in order to offset the additional cost. Given the highly specialised and technical skills required for this role the PBS Entity would draw on relevant technical knowledge from within government, industry and the research community, similar to the Pharmaceutical Benefits Advisory Committee.

Consistent with the approach outlined in the previous section on reforming the health care system, the Commission considers that co-payments should also be increased for use of pharmaceuticals. Some level of contribution should be paid for all medicines under the PBS, including for concessional medicines that are currently free.

For general patients with costs below the safety net, the co-payment could rise by \$5.00 (from up to \$36.90 currently to up to \$41.90) while above the safety net it could also rise by \$5.00 (from \$6.00 currently to \$11.00). To ensure individuals made a greater contribution to meeting their own pharmaceutical needs and to ensure that the Budget was not adversely impacted by the rise in the co-payments, the general patient safety net should increase from \$1,421.20 currently to \$1,613.77.

For concession card holders, there would be no increase to the co-payment (currently \$6.00) below the existing threshold of \$360. However, the Commission considers that introducing a co-payment would be an important step in providing a signal to users about the cost of their care and place greater value on these medicines potentially reducing the incentive that users face to not take their medicines.

Accordingly, once the \$360 threshold is exceeded, concession card holders should pay a co-contribution of \$2.00.

There is also considerable scope to reform the pharmacy retail model to allow greater choice for customers, while ensuring the safe and appropriate dispensing of medicines.

Like much of the health industry, the pharmacy sector is highly regulated and has not been subject to the same level of reform experienced by much of the economy. There remains limited retail choice and competition in the pharmacy sector, with a reliance on community pharmacies to dispense medicines.

Encouraging greater competition within the sector could be undertaken by moving to deregulate pharmacy ownership and location rules. Such reform would be expected to lead to more efficient delivery and the development of alternative retail models - such as pharmacists available to dispense medicines at supermarkets.

Offsetting the impact on pharmacy incomes under this reform would require consideration of a number of issues, including providing pharmacists with opportunities to provide a greater range of services to their customers.

Further improvements could be made to the efficiency of the PBS by reforming associated regulatory processes. The Therapeutic Goods Administration assesses new drugs for safety, quality and efficacy, before they can be supplied on the Australian market. As well as adding to the cost of drugs in Australia, there can also be delays in getting products through this process.

Further reductions to the cost of pharmaceuticals could result from recognising approvals made by overseas agencies, including the United States Food and Drug Administration and the European Medicines Agency. This arrangement would not only reduce the estimated annual cost pharmaceutical companies incur by having to win separate approvals from the Therapeutic Goods Administration but also it would provide better outcomes to consumers as the latest drugs could be brought to the market without being delayed by a lengthy approval process.

Recommendation 19: The Pharmaceutical Benefits Scheme

The Commission recommends changes be made to the Pharmaceutical Benefits Scheme and to the pharmacy sector to improve this integral part of our health system through:

- a. the introduction of new arrangements for funding the Pharmaceutical Benefits Scheme within a set funding envelope that extends for a seven year cycle;
- b. establishing an independent authority ('PBS Entity') to be headed by a suitably qualified Chief Executive Officer who would oversee management of subsidised pharmaceuticals within the Australian health system and be required to report to the Minister for Health;
- c. permitting the Minister in exceptional circumstances to have new items listed by introducing a disallowable instrument into Parliament and on receipt of advice from the PBS Entity regarding items to be de-listed in order to offset additional costs;
- d. increasing co-payments for all medicines under the Pharmaceutical Benefits Scheme, including for concessional medicines that are currently free. This includes:
 - i. for general patients with costs below the safety net, a co-payment increase of \$5.00 (increase from \$36.90 to \$41.90), while above the safety net a rise of \$5.00 (from \$6.00 to \$11.00);
 - ii. in line with the increased co-payment arrangements, the general patient safety net should increase from \$1,421.20 to \$1,613.77; and
 - iii. for concession card holders, no increase to the current co-payment of \$6.00 while below the safety net threshold of \$360.00. However, once the safety net limit has been reached, concession card holders will be required to co-contribute \$2.00 to the cost of their medicines;
- e. opening up the pharmacy sector to competition, including through the deregulation of ownership and location rules; and
- f. streamlining approvals for new drugs through the Therapeutic Goods Administration process by recognising approvals made by certain overseas agencies.

7.5 Family Tax Benefits

Family payments assist families with the costs of raising children. This contributes to the broader objectives of poverty alleviation and social inclusion.

In designing family payments there are trade-offs between the adequacy of assistance, appropriately targeting those in genuine need and maintaining incentives for parents, particularly secondary earners, to participate in the workforce.

Currently Family Tax Benefit (FTB) is the key family payment and is delivered as two separate payments – Parts A and B.

Just under 70 per cent of families with children under 16 (around 1.9 million families) receive FTB-A, at a cost of almost \$15 billion per year.

Some 60 per cent of families with children under 16 (1.6 million or so families) currently receive FTB-B, at a cost of almost \$5 billion per year. Unlike income earned in the workforce, Family Tax Benefit payments are exempt from income tax.

FTB-A is paid per child to assist with the direct costs of children (for example their food and housing). Payment rates increase with the age of the child and with the number of children in a family. The payment is means-tested based on family income, with payments cutting out at an income around \$112,000 for a family with two children under 13 years.

For a family with two children under 13 years, the maximum amount of FTB-A is \$10,607 per year.

FTB-B is designed to provide assistance to sole parents and families where one parent stays home to care for children. FTB-B is paid per family (regardless of the number of children). The means test for this payment covers both the income of the primary earner (which must be below \$150,000) and secondary earner, whereby the payment phases out by 20 cents in the dollar for income earned above \$5,183.

The maximum rates of FTB-B are \$4,241 for families with a child under five and \$3,070 for families whose youngest child is aged 5 to 18 years.

When introduced in 2000, FTB-B replaced six existing payments and inherited mixed objectives including supporting sole parents with the additional costs of sole parenting and couple families where one partner chooses to stay home to care for children. Further details of the current structure of the FTB programme is outlined in Section 9.5 of the Appendix to this report.

Addressing vertical and horizontal equity is a key rationale for the provision of family payments. Vertical equity is the concept that people with lesser means should receive greater assistance, while those with a greater capacity should shoulder a greater financial burden. It suggests that assistance be targeted to families who need it most, with less or no

assistance going to families on higher incomes who are able to provide an acceptable standard of living for their children without additional support.

Horizontal equity is the concept that people with similar capacity to pay should pay a similar amount. Taking into account the costs of their dependent children, families do not have the same financial capacity as an individual or couple on the same income without children. Tax should be paid in proportion to a person's capacity to pay.

Family payments provide assistance but create a disincentive to work, providing income that would otherwise have to be earned through employment. Means testing further reduces the incentive to work as payments are withdrawn as more wage income is earned.

The Commission considers Family Tax Benefit arrangements could be better targeted to those in need and simplified to boost workforce participation. This would be complemented by improvements in childcare payments proposed in Section 7.6.

Better targeting FTB-A

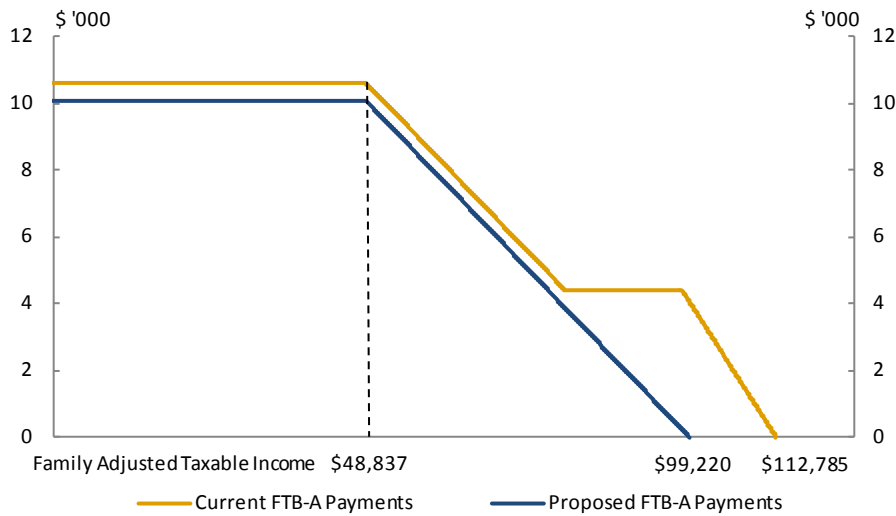
The Commission proposes that eligibility arrangements for FTB-A be tightened and simplified. Arrangements should be changed so that a base rate is no longer included in the scheme's design and instead the existing 20 per cent taper continues to phase out assistance.

This change will not affect low-income families. However, it would effectively remove the base rate of FTB-A – a minimum level of payment that is available to families at the higher end of the income scale.

The income range over which families would be affected would vary with the number and ages of their children.

In the case of an eligible family with two children under 13, under the proposed arrangement FTB-A would be phased out at family income of \$99,220 versus the current cut off income of \$112,785 (Chart 7.9).

Chart 7.9: Existing and proposed rates of FTB-A for a couple with two children under 13 years of age



Source: National Commission of Audit.

Abolishing FTB-B

The Commission notes that FTB-B is not well targeted and can act as a significant disincentive (mainly for women) to participate in the workforce. As stated in the Henry Tax Review, while FTB-A is more than adequate in covering the direct costs of young children, FTB-B has mixed and unclear objectives.

The families who receive the payment include sole parents and couples where the primary income earner can earn up to \$150,000 per year. FTB-B discourages women from working, even part-time, as they bring home a lower proportion of their earnings if they return to work or increase their hours. This problem is exacerbated when more than one means test applies.

The Commission proposes that FTB-B be abolished.

The Commission recognises sole parent families face additional direct costs of raising children. As well as higher costs such as housing, sole parents also have less flexibility in handling unexpected demands on their time such as caring for a sick child. To assist them a supplement (equal to the current value of FTB-B) should be paid to sole parents.

The sole parent supplement should only be paid while children are under eight years of age. Parents have more capacity to earn wage income once children are in school. This is consistent with Parenting Payment (Single), which is available to sole parents until their youngest child is eight.

Further details on the impacts of the Commission's proposals are outlined in Section 9.5 of the Appendix to this report.

The means testing of most government benefits will usually create potential disincentive effects through higher effective marginal tax rates. These effects arise when benefits are tapered or withdrawn as an individual's earnings increase. The interactions of means testing arrangements and the tax system can introduce significant complexities. Changes to the Family Tax Benefit system, including abolishing FTB-B and tightening the targeting of FTB-A, will have an effect on effective marginal tax rates. While in some cases the changes will reduce effective marginal tax rates and increase workforce incentives, in other cases the reverse will occur.

The Commission notes that these matters must be taken into account in the detailed design of new means tests – both for family benefits and elsewhere throughout the welfare system. Further discussion of potential impacts on effective marginal tax rates is also contained in Section 9.5 of the Appendix.

Aligning support to the cost of additional children

The body of research into the direct costs of children has found that there are decreasing costs for each additional child as items purchased for a first child are passed on to siblings.

Studies undertaken by the National Centre for Social and Economic Modelling in 2002, 2007 and 2013 found decreasing marginal costs of children. The most recent study found that on average a second child costs 83 per cent of the costs of the first, while a third child costs 69 per cent of the cost of the first.

To better align family payments to the costs of children, it is recommended that the new FTB-A payment for second and subsequent children be paid at 90 per cent of the maximum rate.

Currently, families with three or more children or who have multiple births receive extra supplements with FTB-A, in addition to being paid the basic rate per child. The Large Family Supplement provides \$314 per year for each third and subsequent child. The Multiple Birth Allowance provides an additional payment of \$3,752 each year for families with triplets or \$4,997 for families with quadruplets or larger multiple births. Given what is known about the costs of children, there is little rationale for these extra payments.

Recommendation 20: Family Tax Benefits

In providing benefits to families there are trade-offs between the adequacy of assistance, targeting it to those in need and maintaining the incentive to work. The Commission recommends Family Tax Benefit arrangements be better targeted to those in need and simplified to boost workforce participation including by:

- a. changing arrangements for Family Tax Benefit Part A by introducing a new single means test, with the maximum rate of the benefit paid up to a family adjusted taxable income of \$48,837 and then phasing out at 20 cents in the dollar until the payment reaches nil;
- b. abolishing Family Tax Benefit Part B;
- c. introducing a new Family Tax Benefit Part A supplement to be paid to sole parent families who have a child under the age of eight. The supplement should be the same as the current maximum rates of Family Tax Benefit Part B (\$4,241 for a family with a child under five, or \$3,070 for those whose youngest child is aged five to eight years);
- d. changing the per child rates to be based on the current Family Tax Benefit Part A rates for a first child and paid at 90 per cent of this for second and subsequent children; and
- e. removing the Large Family Supplement and Multiple Birth Allowance recognising that the costs of children are sufficiently covered by the basic rates.

7.6 Paid Parental Leave and child care

Australia has a significant opportunity to improve the labour force participation rates of women and should do so as a way of lifting growth. Government programmes such as Paid Parental Leave and child care fee assistance play an important role in reducing barriers that discourage women from participating in the workforce.

A government-funded universal Paid Parental Leave scheme was first introduced in 2011. It provides assistance equivalent to the minimum wage (currently \$622.10 per week) to the primary carer of a newborn child for a maximum of 18 weeks. The payment is means tested and a work test also applies. 'Dad and Partner Pay' also provides two weeks of leave paid at the minimum wage for partners of a primary carer.

The Productivity Commission notes it is beneficial for the health of both the baby and mother for the mother to have at least six months off work following birth. A government funded maternity leave scheme ensures access for people who are not covered by employer-funded schemes and avoids employers being discouraged from hiring women of child-bearing age. It is also anticipated that the provision of a national Paid Parental Leave scheme will increase women's labour force participation in the long-term.

The Government will expand the existing scheme from 2015 to provide 26 weeks of pay at the primary carer's replacement wage including superannuation. The existing means test on the payment will be removed, but wage replacement will be capped at incomes of \$150,000.

The increase to 26 weeks of leave and introduction of superannuation payments in 2015 are consistent with Productivity Commission recommendations. The Government is also expanding the scheme to be based on 'wage replacement' (rather than the minimum wage) to recognise Paid Parental Leave as a workplace entitlement.

This change significantly increases the scheme's costs, which are now expected to be over \$5 billion per year in gross terms. Wage replacement also reduces the targeting and progressivity of the scheme.

The Commission recognises Paid Parental Leave has the potential to support maternal and child health and increase women's workforce participation. However, steps should be taken to better balance the objectives of the scheme with the need to restore government finances and to target expenditure to those most in need.

The cap on wage replacement should be lowered from \$150,000 to reduce the costs of the new scheme when it commences on 1 July 2015. Recognising Paid Parental Leave provides a workplace entitlement, a societal standard should be used to set the cap.

The Commission considers that Average Weekly Earnings, currently \$57,460 per year, is a more appropriate cap for the level of wage replacement. This cap would be indexed annually to movements in Average Weekly Earnings.

In seeking to improve the workforce participation of women the Commission acknowledges that the cost and availability of child care can be as important as paid parental leave. Accordingly, the savings from the lower cap should be redirected to fund a proposal to expand eligibility for child care assistance.

That is, the 1.5 per cent levy on company taxable income above \$5 million per year should be retained so that the modified paid parental leave scheme could co-exist with an expanded child care proposal to be implemented in a broadly budget neutral way.

This proposal to expand eligibility for child care assistance is outlined below.

Recommendation 21: Paid Parental Leave

Paid Parental Leave has the potential to support maternal and child health and increase women's workforce participation. The Commission recommends:

- a. targeting expenditure to those most in need by lowering the Paid Parental Leave wage replacement cap to Average Weekly Earnings (currently \$57,460), indexed annually to movements in this wage; and
- b. savings from the lower wage replacement cap be redirected to offset the cost of expanded child care assistance, with the intent of making the changes broadly budget neutral, including retaining the 1.5 per cent levy on company taxable income above \$5 million per year.

Child care

The cost of child care has particular impacts on the workforce participation rates of women, who are more likely than men to take time out of the workforce to care for children. The long-term employment prospects of women are also influenced by the length of time spent out of the labour force.

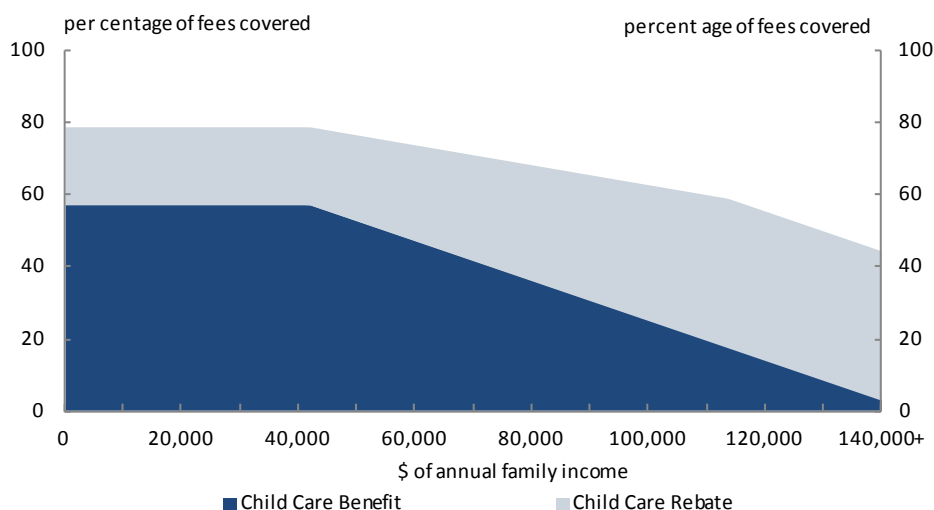
The Productivity Commission is currently undertaking a major review of child care and early childhood learning, with their final report due in October 2014. This inquiry is comprehensive and will cover child care fee assistance and regulation of the sector. The Commission welcomes this review and has made several recommendations that could inform the Productivity Commission's work.

Australia currently has a dual assistance system, where the Child Care Benefit provides a means-tested subsidy per hour of care, while the Child Care Rebate covers 50 per cent of

out-of-pocket costs for all parents up to an annual per-child cap (Chart 7.10). These arrangements are unnecessarily complex.

Support based on a simple reimbursement of a proportion of child care fees would better keep pace with growth in child care costs, simplify administration and make entitlements clearer to those accessing benefits. Further details on the types of subsidised child care are outlined in Section 9.6 of the Appendix to this Report.

Chart 7.10: Percentage of child care fees covered by Child Care Rebate and Child Care Benefit, by family income



Source: National Commission of Audit.
 Note: assumed one child in care for 50 hours per week based at \$7.00 per hour.

The Commission recommends replacing the Child Care Rebate and Child Care Benefit with a single, means-tested payment that reimburses parents for a proportion of child care costs. The new payment should be broadly budget neutral and roughly maintain current levels of assistance of around 80 per cent for low income families, with a base of assistance of 50 per cent available to all families.

Currently parents are able to claim the Child Care Benefit for up to 24 hours of child care per week, after which they must meet a ‘work, training, study test’ demonstrating that they work at least 15 hours per week. Child Care Rebate involves an informal indication that parents spend some time on work or work-related activities each week.

The Commission considers it reasonable that child care should only be subsidised by the Government when it is used to enable parents to work, train or study. It is recommended that in order to claim the new payment to cover *any* amount of child care parents should satisfy a work, training, study test, broadly in line with the amount of child care claimed.

Currently, assistance is only available to families using ‘approved care’ – predominantly either Long Day Care (care provided in a centre) or Family Day Care (provided by a certified provider in their home).

Many families have trouble accessing approved child care that meets their needs. There are often long waiting lists and difficulties associated with trying to place siblings with the same provider. It is particularly hard to access child care outside of 'usual' business hours.

As well as limiting parents' choice, these restrictions have a negative impact on workforce participation. For example, mothers may delay their return to work or work fewer hours because adequate, affordable child care is simply not available.

Lack of flexible care adversely affects people in occupations that require shift or on-call work, such as nursing, policing, retail and hospitality. Many rely on family or friends who care for their children while they are at work.

This issue has been acknowledged by government, although efforts to address it have been piecemeal and fragmented. For example, only a minimal rate of Child Care Benefit (up to \$33.30 per week) can be claimed in respect of 'registered care' provided by relatives, friends or other carers who are registered with the Department of Human Services. However, Child Care Rebate cannot be claimed for registered care, meaning that many parents are not eligible for any support in respect of this type of care.

Similarly, the government subsidises a capped number of places for in-home care where an approved carer comes to the child's home for families in special circumstances (for example where the parent has a disability, the family lives in a remote area or care is not available during the parents' working hours).

The Commission believes that child care fee assistance should support, rather than limit, parents' choice about the type of care they use for their children. The Commission recommends that eligibility for the new child care payment be broadened to include other types of care that are currently not subsidised, for example care by grandparents and paid in-home carers. As an integrity measure, the Commission recommends that parents be required to provide the name and tax file number of their children's carer and the hourly fee that they are paid.

There have been longstanding concerns about the level of regulation in the child care sector, particularly from smaller providers. Some areas of overlap are currently being addressed through the National Quality Framework, however the Framework is also introducing further regulation, such as staff-to-child ratios and qualification requirements, which will be challenging for some providers to meet and add significantly to costs.

As well as the regulation of approved care, the Productivity Commission is also examining the regulation of types of child care that are not currently subsidised and will be reporting on what regulation, if any, should be required. This could inform the design of expanded child care assistance arrangements.

In order to ensure support is well targeted, it is recommended that caps apply to the total amount of rebate received per child per year and the number of hours of care that can be claimed (such as 100 hours per fortnight).

Currently an annual per-child cap of \$7,500 applies to Child Care Rebate. However, with the new payment structure based purely on a percentage of fees being reimbursed, lower income families who receive a greater proportion of their fees back would meet the annual cap faster than higher income families. A proportionately higher cap could be applied to low income families receiving the maximum rate of assistance, for example \$12,000 per child per year, tapering to the current cap of \$7,500 per year for families receiving the 50 per cent rebate.

Recognising that access to child care is fundamental for many women who are seeking to enter the workforce, the Commission proposes that savings that arise from the Commission's recommendations on Paid Parental Leave be redirected to fund this proposal to expand eligibility for child care assistance. It is recommended that the implementation settings (including the caps and the means test) of the new child care payment be designed in order to broadly maintain budget neutrality, taking into account the 1.5 per cent levy on company taxable income above \$5 million per year.

Recommendation 22: Child care

The cost of child care significantly impacts on the ability of parents, particularly women, to participate in the workforce. The Commission recommends the Child Care Rebate and Child Care Benefit be replaced with a single, means-tested payment reimbursing parents for a proportion of their child care costs. The new payment should include a work, training, study test and:

- a. should be broadly budget neutral and roughly maintain the current levels of assistance of around 80 per cent for low income families, with a base of assistance of 50 per cent available to all families;
- b. should include in-home care and other types of care that are not currently subsidised; and
- c. with savings from the Commission's proposed changes to the Paid Parental Leave scheme redirected to offset the cost of this expanded child care assistance, with the intent of making the changes broadly budget neutral, including retaining the 1.5 per cent levy on company taxable income above \$5 million per year.

7.7 Schools funding

School education is a significant area of Commonwealth spending, with forecast expenditure of \$12.9 billion in 2013-14.

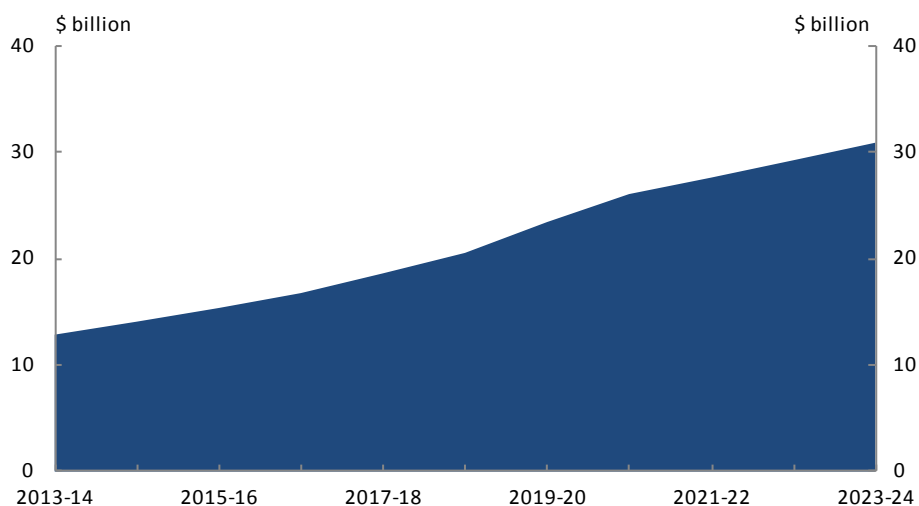
While the Commonwealth does not have specific constitutional responsibility for the provision of school education, it provides significant funds to the States for schools.

Currently, spending on government schools is dominated by the States, which provide over 80 per cent of public funding. Commonwealth spending is primarily directed to non-government schools.

The implementation of the previous Government's *Better Schools Plan* (otherwise known as the Gonski reforms) would see significant growth in Commonwealth spending on schools over the next decade, at an average rate of over 9.2 per cent per year in nominal terms (see Chart 7.11). Key drivers of spending growth include funding indexation arrangements, the transition to a higher 'per-student' rate of funding and growth in student enrolments.

As a consequence of the funding reforms, the relative funding contributions between the Commonwealth and States would change materially. The Commonwealth would no longer be just the primary public funder of non-government schools: it would be a significant funder of government schools' recurrent costs, with the Commonwealth's proportion of contributions projected to increase to around 25 per cent by 2023-24.

Chart 7.11: Projected Commonwealth funding for schools



Source: National Commission of Audit.

The Commission supports government investment in schooling. Strong education contributes to strong employment, as well as broader productivity, health and social outcomes.

However, increasing funding does not necessarily equate to better student outcomes. Between 2000 and 2012, despite real growth in government funding of over 3.8 per cent per year, Australian student results in international tests declined.

The Commission considers that in terms of the efficiency and effectiveness of school funding, what matters most is how schools and classrooms are run. These factors are likely to have a greater impact on student outcomes than spending alone.

The new school funding arrangements are complex, based on a per-student resourcing standard with loadings to take account of student disadvantage.

In theory, the approach is needs-based – it calculates funding according to student characteristics, such as whether they have low socio-economic status, are Indigenous or live in a remote location.

However, the per-student rate of funding that drives the model is not based on a detailed analysis of the cost of delivering education and may not represent its efficient price. Further details on school funding arrangements are outlined in Section 9.7 of the Appendix to this report.

It is not clear to the Commission that the projected step-up of growth in Commonwealth schools funding over the next decade has been sufficiently justified. While the Government has locked in funding agreements for the next four years, new arrangements should apply from 2018 onwards. The amount of ‘per-student’ funding in 2017 should be maintained and then indexed by an appropriate measure to reflect reasonable inflation in school costs.

The Commission also considers roles and responsibilities for school education should be streamlined. As the operators of schools and school systems, the States have much greater day-to-day influence over schooling policy, particularly given they control teacher wages and conditions, hiring and firing decisions and principal autonomy.

Overlapping and duplicative responsibilities and arrangements between the Commonwealth and the States result in significant reporting and compliance burdens for them in what is essentially their area of constitutional responsibility. The Commonwealth’s responsibility for non-government schools adds to this administrative cost.

A simpler arrangement is proposed, whereby the States fund all schools, including the non-government sector.

This should form part of considerations of the broader reforms to federal financial relations outlined in Chapter Six, however the Commission considers progress on schools should be made independent of progress on Commonwealth-State funding reform.

The Commission proposes Commonwealth funding for school education be provided to each State in three pools – one for government schools, one for Catholic systemic schools and one for independent schools.

As occurs now, the Catholic Education Commission in each State would be given responsibility for allocating funding between Catholic systemic schools. Given the mix of small systems (such as the Lutheran system) and completely independent schools in the independent sector, the States would have responsibility for allocating funding within this sector, as well as government schools.

To ensure there would be adequate and ongoing funding in the non-government sector, there would be no capacity to reallocate funding between the pools.

Each State should identify and publish its own needs-based formula for allocating school funding. They should also publish data on school outcomes on a consistent basis and continue to participate in national and international testing and the national curriculum. Other than that, there would be minimal reporting to the Commonwealth.

Under this approach a significant reduction in the size of the Commonwealth Department of Education could be achieved.

Recommendation 23: Schools funding

While the Commonwealth does not have specific constitutional responsibility for school education, it provides significant funding to the States. The Commission recommends changing funding arrangements to simplify Commonwealth-State responsibilities and make school funding more affordable by:

- a. transferring all policy and funding responsibility for government and non-government schools to the States, with annual funding provided in three separate, non-transferrable pools - one each for government schools; Catholic systemic schools and independent schools;
- b. applying requirements on the States to:
 - i. publish how they allocate funds to schools;
 - ii. participate in national and international testing; and
 - iii. publish student outcomes on a consistent basis;
- c. basing Commonwealth funding from 2018 onwards on 2017 levels, with:
 - i. a 2017 per student funding amount calculated for the government and non-government school sectors in each State and Territory;
 - ii. annual funding for each sector in each jurisdiction calculated as the per-student amount, adjusted for the number of students enrolled in that year and indexed by a weighted average of the CPI and the relevant Wage Price Index; and
- d. significantly reducing the size of the Commonwealth Department of Education.

7.8 Defence

Defence spending constitutes a significant part of the Commonwealth Budget. At \$25.3 billion, it represents around 6 per cent of all Commonwealth expenditure.

The Government's stated position is that the nation's defence and security is its first priority. It has made a number of commitments in this area including no further cuts to defence spending; and that funding will reach 2 per cent of GDP within a decade.

The Commission considers the starting proposition for Defence funding should be to determine the defence capability required to successfully counter the various strategic risks Australia could face and then match this with appropriate funding to address the highest priority ones.

This approach must recognise the intrinsic long-term nature of acquiring, operating and maintaining military equipment, but also requires an expectation that Defence will efficiently use its resources.

The Government has also committed to a first principles review of the Department of Defence and all of its major processes, with a focus on achieving more streamlined and less bureaucratic decision making, bolstering ministerial control, reducing waste and restoring authority to the commanders responsible for delivering war-fighting capability.

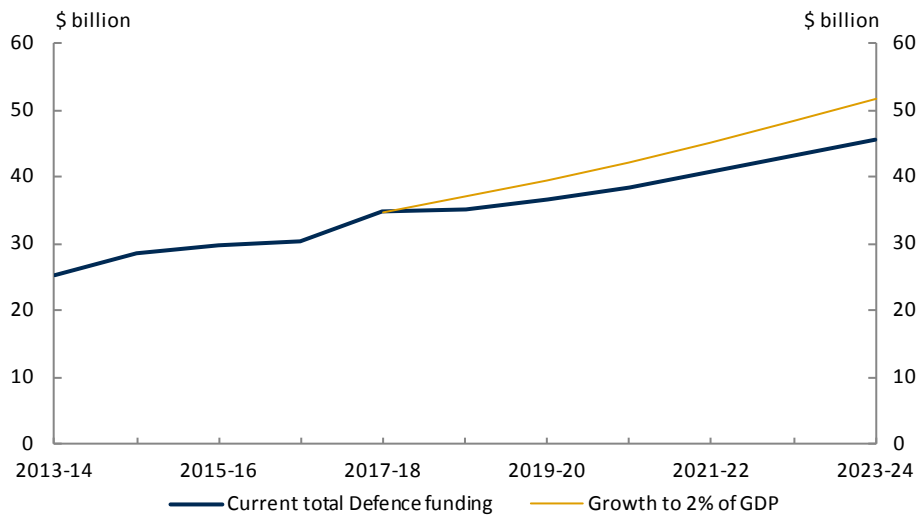
Spending on Defence grew by 2.7 per cent per year in real terms from 2001-02 to 2013-14. This growth was driven by policy decisions reflecting increased concerns about international terrorism as well as the number of overseas operations involving Australian forces. Over the last few years, spending growth moderated.

Defence spending faces ongoing cost pressures, reflecting the growing cost of military equipment (often associated with increased capability) and increasing personnel costs.

In the absence of organisational and structural reform, the 2013 Defence White Paper and Defence's planned timeframe for its capability and facilities requirements is unlikely to be afforded within the current budget and forward estimates and Defence funding guidance to 2022-23.

Meeting the commitment to increase Defence spending to reach 2 per cent of GDP implies considerable growth in expenditure over coming years (Chart 7.12). It will also be crucial to ensure that any run up in acquisitions can be efficiently accommodated by both Defence and industry and that value for money remains paramount in project selection and implementation.

Chart 7.12: Projected Defence funding



Source: National Commission of Audit.

Strategic assessments

In its submission to the Commission, the Australian Strategic Policy Institute noted that over the past 30 years governments have consistently failed to deliver the funding commitments Defence has used to formulate plans.

Determining what is required to secure Australia’s security interests, and estimating what it will cost, should be the job of the 2015 Defence White Paper.

The Commission considers a sensible way of approaching this task is for the Government to use the White Paper process to consider the strategic risks and associated capability requirements that different levels of funding can address. As part of this process, the Government should also assess the balance of strategic and fiscal priorities and how this compares with the 2 per cent of GDP spending commitment. This should result in a better balance between risk and resourcing – and implies a force structure focused on the most important threats.

Efficiency and transparency

Regardless of how governments choose to address the balance of defence resourcing with Australia’s strategic security interests, any growth guarantee must come with an obligation to ensure funding is used efficiently.

As a former Chief of the Defence Force has noted ‘there is a simple imperative at work here. The efficiency with which Defence manages its resources and controls its business has a direct impact on our nation’s defence capability and military effectiveness.’

Defence has a mixed record in improving its efficiency. There is no doubt securing greater efficiency in Defence is a major challenge. Contemporary defence systems and assets can be

amongst the largest and most sophisticated engineering projects nations undertake. Predicting their costs and completion time can be difficult.

A major issue is the difficulty in instituting and sustaining change in Defence. The Commission notes that there have been numerous examinations of Defence and its efficiency – with more than 10 major reviews since 1982. These reviews consistently highlighted similar issues. The Defence Management Review in 2007, for example, attributed Defence’s lack of dynamism and responsiveness to accountability structures, business processes, the quality and availability of management information, the preparation of senior managers and prevailing attitudes.

The Defence budget needs greater scrutiny and a more strategic and effective approach to settling and managing spending. Australian taxpayers have a right to be better informed about defence spending and its composition. Greater scrutiny should come through the Government’s broader budget process including through the Expenditure Review Committee. In particular, a pre-condition for setting the new funding profile for Defence under the White Paper should include improvement to the effectiveness and transparency of expenditure by enhancing Defence budget arrangements and governance, capability development and delivery mechanisms.

One way to do this is to move from the traditional ‘single line’ budget to an approach that separates expenditure on future capability — including the Defence Capability Plan, facilities and information and communications technology capital programmes and any associated increases in operating costs — from outlays on current activities.

Funding for future capability could be held in a separate budget allocation and released to Defence as ‘administered’ funding rather than ‘departmental’ funding as proposals are considered. This would ensure a greater degree of financial control over and scrutiny of Defence spending.

As strategy discussions can pre-ordain future funding, the Commission also considers that there would be merit in ensuring that the Minister for Finance participated in strategic policy deliberations relating to Defence undertaken by the National Security Committee of Cabinet.

It is not clear that Defence Headquarters in Canberra has the capacity to drive efficiency and better policy outcomes as the organisation has grown more complex and top-heavy over the years.

Since 2000 the number of public service senior executives in Defence has grown by 63 per cent (from 103 to 168) and the number of serving star ranked officers by 58 per cent (from 120 to 190). Since 1996 the number of three-star officers (lieutenant general equivalent) has grown from four to seven, while the number of deputy secretaries in Defence has increased from four to 14.

A simpler and leaner structure is a priority. The Department of Defence should be required to monitor and publish information on the number of personnel in the combat force, Defence headquarters and support roles. A particular focus should be the ratio of the combat force to other personnel (the so called 'teeth to tail' ratio). Defence should develop a programme to improve this over time.

At the same time, staffing in Defence Headquarters, including the numbers of star-ranked and Senior Executive Service officers, should return to the 1998 level.

The higher organisation of the Department of Defence and the Australian Defence Force, and the joint leadership through the Secretary and Chief of the Defence Force — an arrangement known as 'the diarchy' — runs the risk of blurred accountabilities.

The Commission considers accountabilities within the diarchy could be improved by a ministerial directive, which clearly sets out the separate responsibilities of the Secretary of the Department and the Chief of the Defence Force along the lines shown in Box 7.1. This would form a basis for ensuring that the Secretary and Chief of the Defence Force are held individually accountable for Defence's performance.

Scope exists to simplify conditions of service for both military and civilian personnel. The complexity of military conditions of service can add significant overheads, however they need to deliver benefits in terms of retention and recruitment. Conditions for civilian personnel need to ensure sufficient management flexibility and focus on performance.

Options should be considered to streamline military and civilian conditions of service, with a view to reducing overheads, promoting performance and management flexibility and providing a simplified package of benefits for staff. As outlined in Section 5.2, the Commission recommends closing the Military Superannuation and Benefits Scheme to new entrants and introducing a new accumulation scheme to provide superannuation for military personnel. Indexation for the Defence Force Retirement and Death Benefits Scheme and Defence Force Retirement Benefits Scheme pensions should remain linked to movements in the CPI.

Defence procurement and the Defence Materiel Organisation

While governments will typically seek the most appropriate capability at the least cost, at times governments will also seek to use defence acquisitions to leverage support for industry policy. This obscures transparency of industry assistance and corrupts Defence budget processes.

A major driver of defence costs is the preference for unique and Australian built equipment. In the case of the Air Warfare Destroyer and Landing Helicopter Dock ship projects the premiums in the prices tendered for an Australian build were considerable. The effective rate of assistance is estimated at about 30 per cent for the destroyers and over 100 per cent for some of the helicopter ship options. Choosing to support Australian industry cost billions of dollars. In effect, a foreign build could have provided an extra ship in each class for the same cost.

Using Defence for industry policy support comes at a price and the Commission considers that governments must be clear and transparent on these issues.

The future of the Defence Materiel Organisation (DMO) and its counterpart in the department, the Capability Development Group, must also be considered.

The DMO's mission is to equip and sustain the Australian Defence Force. In the Commission's opinion the 2005 decision to create the DMO as a statutory independent organisation outside the Department of Defence, under a purchaser provider arrangement, has not worked. It has not been effective in enhancing accountability.

The Commission received a number of submissions that highlighted shortcomings of DMO and the Capability Development Group. These included: high turnover of military staff; project management and costing skills shortages; unnecessarily complex contracting arrangements; underestimation of initial project costs; a lack of independent scrutiny; inadequate identification of technical risks; and unreliable whole-of-life cost estimates.

Ensuring all parts of the capability process reside within Defence — including a much smaller DMO focussed predominantly on contract management rather than detailed project management — will allow for a more integrated view of the capability process, better defined accountabilities and better sharing of information. It will serve as a basis to address the shared problems faced by DMO and Capability Development Group. A more professional Capability Development Group could be achieved by ensuring it was headed by a senior policy officer experienced in independent analysis of contending military equipment and with staff recruited from a new professional capability development career stream.

The Commission understands that significant challenges have been encountered with budget and accounting issues and with reconciliation of accounts and payments across DMO

and Defence systems. The rationalisation of financial management systems could help improve the business management of the DMO-Defence relationship.

The Commission considers that the DMO should be fully integrated into the Department of Defence. While the DMO's Chief Executive could continue to provide independent advice about major capital projects to government in a manner similar to that of the Chief Defence Scientist who also provides independent advice to government about major projects on behalf of the Defence Science and Technology Organisation. This arrangement would provide potential for greater cost savings across corporate activities.

Recommendation 24: Defence

Ensuring the nation's defence and security is a core function of the Commonwealth Government. The Commission recommends a number of steps be taken to improve the efficiency, effectiveness, accountability and transparency of Defence spending through:

- a. ensuring preparation of the new Defence White Paper identifies capability options and associated costs for different sets of strategic risks. As part of this process, the Government should also assess the balance of strategic and fiscal priorities and how this compares with the commitment to increase Defence expenditure to 2 per cent of GDP within a decade;
- b. as a pre-condition for setting any new funding profile for Defence under the White Paper, the Government should ensure that Defence improves the effectiveness and transparency of expenditure by improving Defence budget arrangements and governance, capability development and delivery;
- c. transparency and control for government should be significantly improved by stronger budget processes including through the Expenditure Review Committee. For new capital, in particular new equipment projects, this would include holding funds in separate budget allocations and releasing them as projects are approved. Such expenditure should be treated as administered funding rather than departmental funding, so that there is greater financial control and scrutiny of this expenditure through established budget processes;
- d. a new ministerial directive to the Secretary of the Department of Defence and the Chief of the Defence Force specifying their separate and shared responsibilities and holding them individually accountable for Defence performance;
- e. reintegrating the Defence Materiel Organisation into the Department of Defence, with the size of the Defence Materiel Organisation being significantly reduced and with a renewed focus on contract management as opposed to project management;
- f. establishing a more professional Capability Development Group within Defence with an increased use of project development professionals skilled in cost and risk assessment;
- g. reducing the staffing size of Defence headquarters in Canberra, including senior staff, to 1998 levels; and
- h. Defence publishing performance indicators that reveal progress with reform, including the 'teeth to tail' ratio and the additional cost of unique and Australian built procurement decisions.

Box 7.1: Draft ministerial directive on Defence responsibilities

MINISTER FOR DEFENCE

MINISTERIAL DIRECTIVE TO:

SECRETARY OF THE DEPARTMENT OF DEFENCE

CHIEF OF THE DEFENCE FORCE

Preamble: In accordance with my powers under section 8 of the *Defence Act 1903*, I hereby issue the following directive to the Chief of the Defence Force and the Secretary of the Department of Defence.

Accountability: You are **jointly responsible** to me for the management of the Australian Defence Organisation as an integrated organisation including the Department of Defence and the Australian Defence Force. You are accountable to me for Defence's performance, having regard to our statutory responsibilities. Any authorisation or delegation of my authority with respect to Defence is through you, within the limitations below.

Results: I expect you, jointly and individually, to deliver an efficient and capable defence organisation, optimised to address the strategic priorities agreed by Government as the most significant, through:

Responsibilities of the Secretary of the Department of Defence:

- a. timely, accurate, coordinated and considered advice as my principal civilian adviser;
- b. not limiting your responsibilities under the *Financial Management and Accountability Act 1997* and the *Public Governance, Performance and Accountability Act 2013*, sound management of financial and other resources, operating within budgeted financial performance, meeting statutory requirements for preparing financial statements and optimal management and use of the Defence estate; you will ensure those exercising your delegations (including military personnel) focus on achieving value for money;
- c. not limiting your responsibilities under the *Public Service Act 1999*, proper stewardship of the public service workforce, through developing and maintaining workforce skills and career structures, building and maintaining Defence's reputation and providing a living and working environment that attracts and retains people;
- d. acquisition and sustainment of all major capital equipment and logistics pertaining to sustainment of capability;
- e. advising on the performance of entities within the portfolio as identified in my separate directive or statement of expectations to those entities;

- f. not limiting your responsibilities under the *Archives Act 1983*, proper management of information and records within Defence;
- g. the provision of support services, including infrastructure, personnel, legal, health, travel, publishing and printing, library services, mail and freight, business transaction processing, base services and administrative support;
- h. the provision of information and communications technology; and
- i. the provision of Defence science research.

Responsibilities of the Chief of the Defence Force:

- a. timely, accurate, coordinated and considered advice as my principal military adviser;
- b. operational deployment of the ADF to enhance our national strategic interests and our alliance relationships, to strengthen regional security and to successfully conduct joint military exercises and operations;
- c. adequate preparedness of forces and the preparation of military policy and plans;
- d. not limiting your responsibilities under the *Defence Act 1903* and related legislation, proper stewardship of the military workforce, through developing and maintaining workforce skills and career structures, building and maintaining Defence's reputation and providing a living and working environment that attracts and retains people;
- e. management of operational logistics; and
- f. management of military information and communications technology.

Joint Responsibilities of the Secretary of the Department of Defence and the Chief of the Defence Force:

- a. management of the Australian Defence Organisation, including the setting of organisational goals and responsibilities, the design of the organisation and its business processes, measurement and reporting of performance and the establishment of organisational policies;
- b. development of advice to government and strategic policy for use within Defence reflecting the best response to Australia's changing international environment;
- c. identification, development and provision of current and future capability to enable our armed forces to defend Australia and its national interests;
- d. intelligence capabilities, responsive to whole-of-government requirements;
- e. continual development of the Australian Defence Organisation so that it works in a more holistic, responsive, efficient and effective manner; and

- f. planning, evaluation and reporting documents, incorporating matters related to your individual and joint responsibilities, that provide transparency and support value-for-money decision-making with Government and Defence.

Guidance: You should pursue these results through effective leadership and management and should ensure that:

- a. your actions are prudent, lawful and ethical;
- b. your actions are consistent with Government policy;
- c. you make decisions and offer advice, considering:
 - i. the impact on relationships with others who contribute to national security, including with the leadership of foreign Armed Forces and other Australian agencies with national security interests;
 - ii. the statutory responsibilities of appointments within Defence;
 - iii. the impact on resourcing and the risk to the sustainable delivery of Defence outputs; and
- d. the CDF's proposals for promotions to Brigadier equivalent and above are made in consultation with the Secretary, Vice Chief of the Defence Force and the Service Chiefs.

Previous Directives: This directive replaces all previous ministerial directives to the Chief of the Defence Force and the Secretary of the Department of Defence.

7.9 Aged care

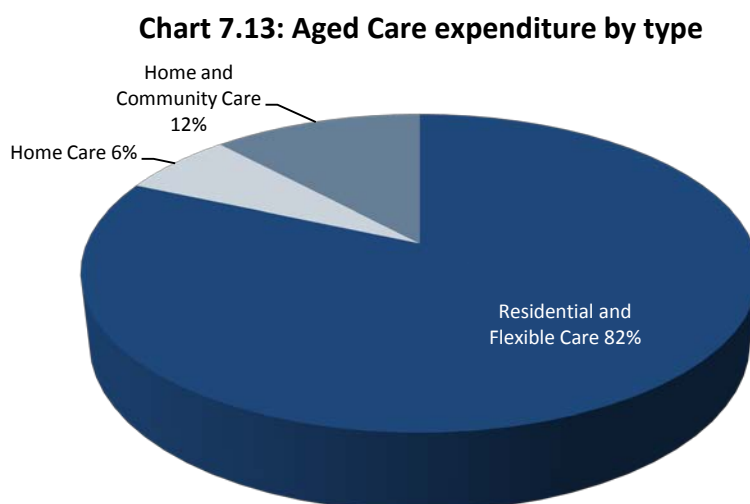
Currently around 1 million older Australians receive some form of aged care support. The majority of these are people who receive services in their own home and the community. Around 200,000 people are in permanent residential care.

With the ageing of the population, the number of Australians aged 65 and over will rise rapidly, from roughly 3 million today to over 8 million by 2050. Moreover, by 2050 it is expected that more than 3.5 million people will need access to aged care services, with around 80 per cent of these delivered in the community.

There is a strong rationale for government involvement in aged care on equity grounds and also to overcome information gaps and protect vulnerable Australians. However, over recent years there has been increased acceptance and use of private co-contributions toward the cost of care.

Formal aged care services are predominantly financed by government, with supplementary user contributions also required in many areas. Public funding is primarily delivered through payments to the providers of the various care services.

Aged care expenditure is expected to be around \$13 billion in 2013-14, with strong growth expected over coming years. Expenditure on aged care is currently growing at around 4 to 5 per cent per year in real terms. As shown in Chart 7.13, residential age care is the single largest area of expenditure. Expenditure is being driven primarily by demographic and health factors.



Source: National Commission of Audit.

Within residential aged care, the Commonwealth provides approximately 71 per cent of funding, of which 80 per cent is provided via the Aged Care Funding Instrument – the mechanism used to allocate Commonwealth Government subsidies. The next most significant funding source is resident care fees, which make up 25 per cent of total funding,

followed by revenue from accommodation payments (including regular accommodation payments and amounts from accommodation bonds) at about 4 per cent of total funding.

Residents in aged care facilities who have sufficient assets can be asked to pay for their accommodation through an accommodation bond or through a periodic fee, depending on the type of aged care they receive. These are a significant source of funds for providers, and represent 48 per cent of assets for the sector. An estimated 84.7 per cent of aged care homes held accommodation bonds at 30 June 2012.

Significant reforms to the aged care sector are already being implemented under the *Living Longer, Living Better* package. This package aims to contain growth in expenditure, strengthen price signals and increase incentives for self provision by reforming funding arrangements. The reforms are being implemented over a five year period, with a review scheduled in 2016-17 to identify any further adjustments or improvements required.

While this reform package will do much to improve services and affordability, the Commission considers that additional measures are still needed to ensure effectiveness and sustainability of government programmes in this area.

The Commission notes that significant changes to the means testing arrangements for both residential and home care services will apply from 1 July 2014. The current income and assets tests for residential care will be combined. An annual cap of \$25,000 will apply to a resident's means tested contribution to their care costs, together with a lifetime cap of \$60,000 for means-tested care fees. The principal residence will continue to be exempt from the assets test if occupied by a spouse or other protected person. However, it will be taken into account when determining a resident's contribution to their accommodation payment.

The Productivity Commission in its *Caring for Older Australians* report recommended that for both residential care and home care services means testing arrangements should be strengthened. The current means test for residential aged care takes partial account of the value of the principal residence, up to a cap of \$144,000, substantially lower than the current median house value of \$445,000. This means test should take account of the full value of the principal residence.

The Productivity Commission also suggested that a government backed aged care equity scheme could be established to enable older people with wealth primarily in the form of a home, accommodation bond or other non-liquid assets to draw down on those assets to meet their aged care costs.

This could apply to non-residential aged care. In order for this to occur, the Government would need to implement arrangements to promote reverse mortgages and other products to access housing equity. Such schemes have been adopted in other countries and could be used as a template for reforms in Australia.

Residents in aged care facilities who have sufficient assets can be asked to pay for their accommodation through an accommodation bond or through a periodic fee, depending on the type of aged care they receive.

Under the accommodation bonds guarantee scheme, the Commonwealth Government guarantees the repayment of the bond balance if the aged care provider becomes bankrupt or insolvent and is unable to repay the outstanding bond balance. In return, the residents' rights to pursue the defaulting provider to recover the accommodation bond money transfer to the government. There is little rationale for this contingent liability to be borne solely by the Commonwealth.

Consistent with the recommendations outlined above in Section 5.1 on better managing the Commonwealth's balance sheet, the Commission recommends that a fee should be charged on providers covered by the accommodation bond guarantee. Alternatively, providers should be required to source appropriate insurance from the private sector, allowing the government to withdraw from these arrangements altogether.

Currently, not-for-profit providers of residential care are exempt from paying State governments' payroll tax. In the interests of competitive neutrality, the Commonwealth currently refunds for-profit providers for the payroll tax that they pay. The Commission recommends that this supplement should be terminated, as it is effectively shifting the payment of a State tax to the Commonwealth.

The aged care sector is categorised by a high level of regulation, which applies to price, quantity and quality. There would be benefit in reducing duplication in many aspects of financial reporting and reducing other regulatory requirements for aged care providers. The Commission suggests that this issue be pursued further by the Commonwealth Minister as part of the implementation of its recommendations on aged care.

Recommendation 25: Aged care

With the ageing of the population, more Australians will be receiving some form of aged care support. The Commission supports the range of reforms currently being introduced in the aged care sector, but recommends additional measures be undertaken to improve the effectiveness and sustainability of the sector by:

- a. including the full value of the principal residence in the current aged care means test;
- b. implementing arrangements to allow older Australians to access equity in their principal residence, to pay for part of the cost of their aged care services;
- c. introducing a fee for aged care providers to access the accommodation bond guarantee or, alternatively, requiring providers to take out appropriate private insurance to cover the risk of default;
- d. terminating the Payroll Tax Supplement; and
- e. reducing duplication in all aspects of financial reporting for the aged care sector as well as reducing other regulatory requirements for aged care providers.

7.10 Carer payments

Many Australians choose to, or have no choice but to, care for their family members and friends who are unable to care for themselves. The Commission recognises that if this type of informal care was not provided, it would need to be provided formally and mostly by government at a much higher cost.

There are approximately 220,000 people receiving Carer Payment in Australia. Around 90 per cent of these people have no private earnings – because of the demands of their caring role they are unable to earn a wage through paid employment.

The government provides income support to carers in the form of Carer Payment in recognition of the sacrifices that carers make including the foregone income that they would otherwise be able to earn.

As well as Carer Payment a Carer Allowance is available to someone who provides daily care and attention to someone in their own home. Around 560,000 people receive the Carer Allowance which is not means tested. There is also an annual Carer Supplement payable to eligible carers for each person in their care.

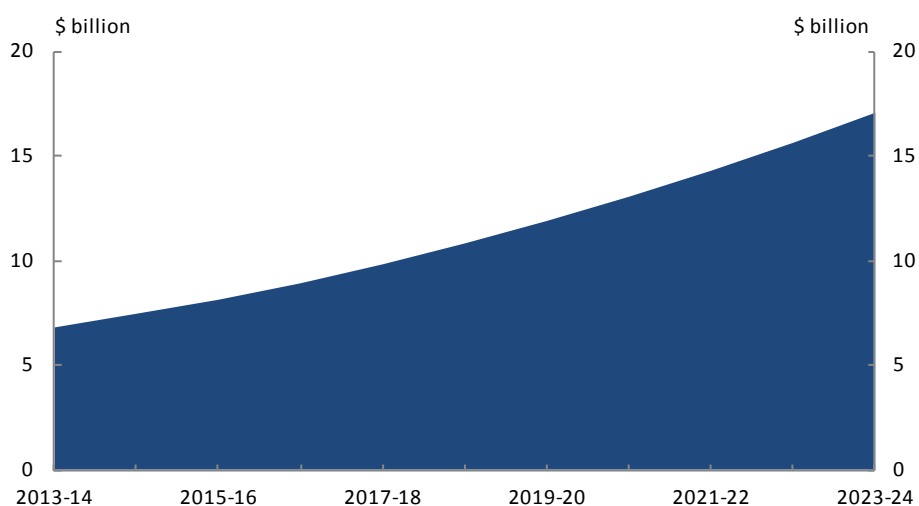
Payments to carers are significant, totalling nearly \$7 billion in 2013-14 and growing in excess of 6 per cent over the forward estimates in real terms. See Chart 7.14.

The number of Carer Payment recipients has been growing at 12 per cent each year over the last decade. This growth greatly outstrips growth in the population. The number of recipients of Carer Allowance has also grown rapidly, more than doubling over the last decade.

Consistent with its principles, the Commission supports the continuation of payments to carers. However, certain payments made to carers could be better targeted and it would also be appropriate to re-examine the eligibility criteria for the Carer Payment given the rapid growth in the number of recipients.

Currently, a carer may receive more than one payment of Carer Supplement each year. This can occur where the carer receives certain combinations of government payments. Additionally, as the Carer Allowance is paid for each person in care it is also possible to receive more than two Carer Supplements per year.

Chart 7.14: Projected spending on income support for carers



Source: National Commission of Audit.

The introduction of the National Disability Insurance Scheme and its interactions with carer payments have not been fully scoped. As the NDIS is fully rolled out, these interactions need to be properly analysed.

Complexity of the payment arrangements and differing eligibility requirements suggest that there could be gains from streamlining arrangements. This could include examining the case for retaining a series of one-off payments, rather than integrating these into the Carer Payment and/or Carer Allowance.

As the Carer Supplement is an annual lump-sum payment, it should only be paid once to each carer in recognition of their caring efforts. The number of people receiving the Supplement would be unaffected by this change.

There is currently no means test for the Carer Allowance. As such, carers with substantial incomes can receive a payment of around \$118 per fortnight. In keeping with the Commission's focus on targeting payments to those most in need, an income test should be introduced for Carer Allowance. Setting an income limit of \$150,000 per year would affect the payment of the Allowance for a small number of existing recipients.

Eligibility criteria should be reviewed to ensure that the Carer Payment is going to those in genuine need and the principles of equity are maintained.

Recommendations relating to changes in the Age Pension benchmark will flow through to the Carer Payment. Transitioning the Carer Payment to the new benchmark of 28 per cent of Average Weekly Earnings should apply at the same time as implementation of those changes to the Age Pension benchmark.

It would be a matter for Government to decide how and when the eligibility changes apply to Carer Payment recipients (recognising that for the Age Pension these eligibility

requirements apply prospectively to new recipients from 2027-28). These include a more comprehensive means test; and an increase in the income test taper rate from 50 per cent to 75 per cent. The Commission notes however that only a small number of recipients of Carer Payment (less than 10 per cent) would likely be affected by changes to the means test.

Recommendation 26: Carer payments

Many Australians care for a family member or friend who is unable to care for themselves. The Commission recommends payments to carers be maintained, but recommends changes to improve targeting including:

- a. limiting the annual Carer Supplement to only one payment per carer;
- b. introducing an income test for the Carer Allowance, set at \$150,000 per year;
- c. reviewing eligibility criteria applying to the type of care provided and to the needs of the adult receiving care. This should ensure that Carer Payment is targeted to those whose caring responsibilities limit their capacity to work; and
- d. aligning Carer Payment arrangements with the Commission's recommended changes to the Age Pension benchmark by transitioning to a new benchmark of 28 per cent of Average Weekly Earnings at the same time as implementation of the Age Pension benchmark changes.

7.11 Unemployment benefits and the minimum wage

Unemployment benefits and services play an important role in assisting unemployed people back into paid employment. Newstart Allowance is the primary form of income support for the unemployed.

Newstart is designed to provide a minimum adequate standard of living for people who are temporarily out of work and unable to support themselves through their savings, or other means. The rate of payment attempts to balance adequacy of support for people who are unemployed with incentives for them to seek work as well as the cost to taxpayers.

A wide range of employment assistance is currently provided to unemployed Australians. With the aid of Job Services Australia, most young people find employment relatively quickly.

The Commission considers Australia's current unemployment benefit arrangements should be retained as a major pillar of the social safety net. However, building on recent reforms, changes should be made to improve incentives to work and job opportunities for the unemployed.

It is particularly important young people do not fall into long-term unemployment.

Given the significant support available and the relatively large numbers of younger unemployed, the Commission considers it reasonable to expect young long-term unemployed people to improve their job prospects by requiring those aged 22 to 30 to relocate to a high employment area, once they have been unemployed for more than 12 months.

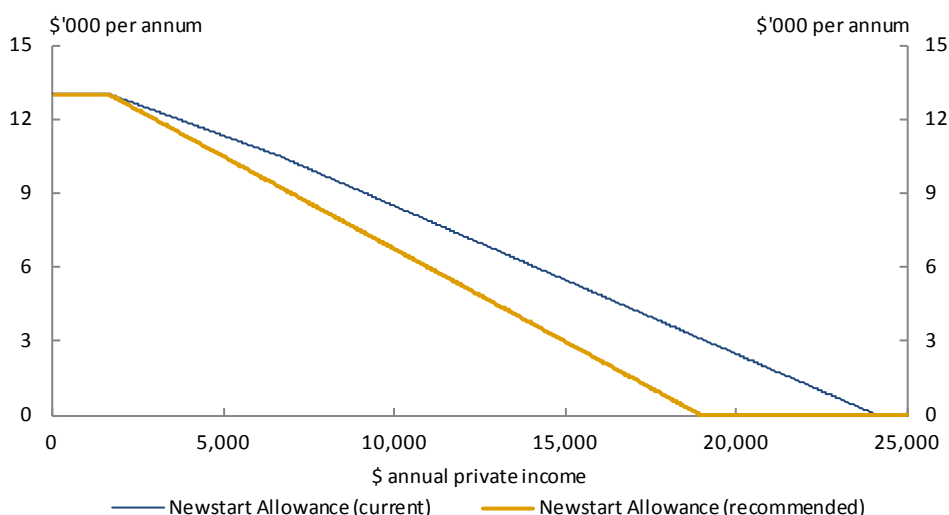
Currently, people who are out of work lose access to unemployment benefits if they relocate to low employment areas without a good reason. This policy extends a similar logic to failure to relocate to areas of high employment.

The Commission considers special exemptions to this change should be available for people with dependent children or who have similar commitments or responsibilities. More than half of Newstart Allowance recipients are single and have no dependents.

Support now exists to assist young long-term unemployed people to move. Based on existing policies, relocation assistance of \$6,000 is available if an unemployed person moves to a regional area to take up a job or \$3,000 if they move to a metropolitan area. A Job Commitment Bonus of \$2,500, and up to \$4,000, is available for people who, having found a job, remain off welfare for a sustained period of time.

As shown in Chart 7.15 in relation to Newstart means testing arrangements, unemployed people with private income of around \$25,000 per year can still access some income support. This is almost twice the maximum payment of Newstart and is a relatively high amount of private income while still entitling a person to a safety net payment.

Chart 7.15: Newstart Allowance payment rates and income tests



Source: Department of Human Services.

The Commission recommends the income test withdrawal (taper) rate should be increased to 75 per cent for Newstart and other related allowances. This represents a more appropriate targeting of safety net payments.

Recommendation 27: Unemployment benefits

Unemployment benefits play an important role in assisting people back into work. Building on recent reforms, the Commission recommends a number of changes be made to improve incentives to work including by:

- a. requiring young single people aged 22 to 30 without dependants or special exemptions to relocate to higher employment areas or lose access to benefits after a period of 12 months on benefit; and
- b. increasing the income test withdrawal (taper) rate to 75 per cent for Newstart recipients and other related allowances.

Another important dimension to government programmes designed to get people back to work is the relationship between the rate of income support and the minimum wage.

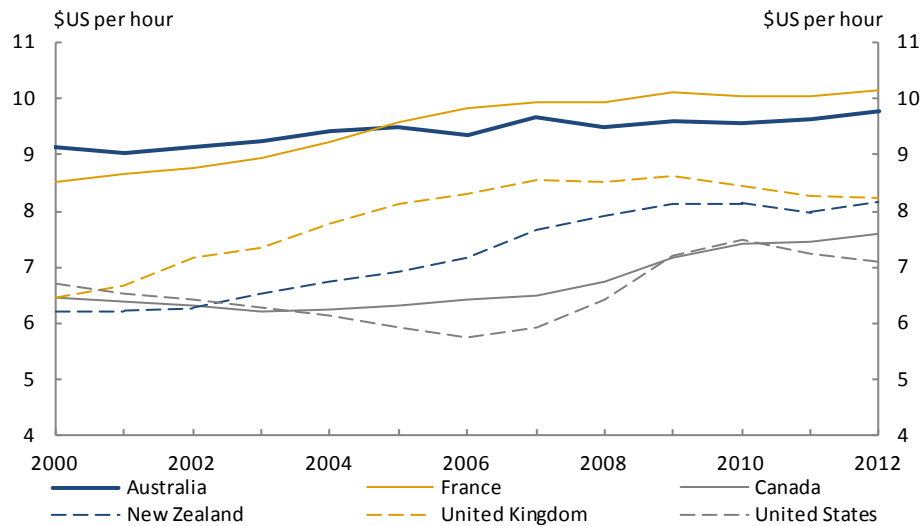
If the level of income support is too close to the minimum wage then some recipients have little incentive to obtain work. Alternatively, if the minimum wage is too high relative to income support then many unemployed people — particularly the low skilled and inexperienced — will be priced out of the labour market and struggle to find employment.

A minimum wage that is too high prevents groups, such as young job seekers, from entering the labour market, inhibiting the development of workplace skills and experience that could increase their wages over time. An excessively high minimum wage is also likely to act as an impediment to the effectiveness of government programmes to get people back to work.

At present Australia's youth unemployment rate is around 12 per cent compared with just under 6 per cent for the overall national unemployment rate.

As shown in Chart 7.16, Australia's minimum wage is high by international standards. Containing growth in the minimum wage would improve job opportunities and the effectiveness of the Government's employment policy programmes.

Chart 7.16: Minimum wage, selected OECD countries, 2011-12 \$US in purchasing power parity terms



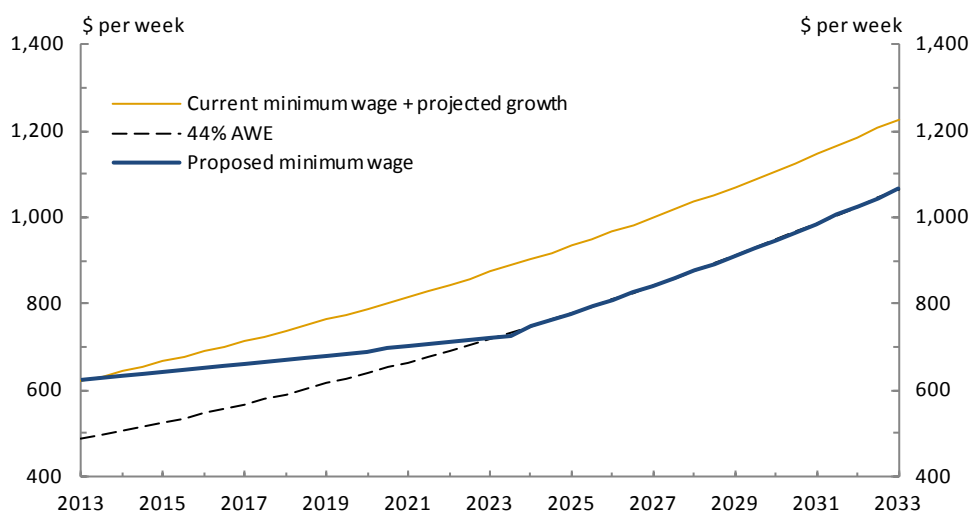
Source: OECD.

In transitioning to new arrangements that contain growth in the minimum wage, it is important to consider its objectives. It should have regard to community standards but also maintain the incentive to work in terms of the relativity between unemployment benefits and financial benefits of working.

The Commission proposes that growth in the minimum wage be slowed by applying an indexation factor of CPI less 1 percentage point for a period of 10 years (growth of around 1.5 per cent per year) until it reaches 44 per cent of National Average Weekly Earnings.

As shown in Chart 7.17, under this arrangement the minimum wage would continue to grow over time in nominal terms but at a slower rate than under current arrangements. After this decade has elapsed the minimum wage would be indexed in line with growth in National Average Weekly Earnings.

Chart 7.17: Proposed transition to a new Minimum Wage Benchmark



Source: National Commission of Audit.

This method would establish a ‘Minimum Wage Benchmark’ from which a degree of variation across the nation could be introduced. Having a uniform national minimum wage ignores substantial differences in local job markets. The demand for labour and the price employers are willing to pay for unskilled or inexperienced labour varies markedly across the country.

Having a single national minimum wage disadvantages workers attempting to gain a job in states like Tasmania and South Australia where wages and the costs of living are generally lower than in other States.

There are wide differences in wage rates between States. While the minimum wage is around 45 per cent of the Australian Capital Territory Average Weekly Earnings, it is around 65 per cent of Average Weekly Earnings in Tasmania.

The Commission recommends that a different minimum wage apply in each jurisdiction, with a transition period over the next 10 years. In particular, the Commission proposes the minimum wage in each jurisdiction be equal to the lower of the Minimum Wage Benchmark described above, or 44 per cent of Average Weekly Earnings in that jurisdiction by 2023. The wage would then increase in line with growth in that jurisdiction’s Average Weekly Earnings.

The Commission considers that the Government should introduce these new arrangements to the extent it has constitutional power, or work with the States to ensure implementation.

Recommendation 28: The minimum wage

Australia's minimum wage is high by international standards. The Commission recommends that future growth in the minimum wage be contained to improve job opportunities. A degree of variation in the minimum wage should also be introduced across the States to better reflect local labour market conditions and the cost of living. This should be achieved by:

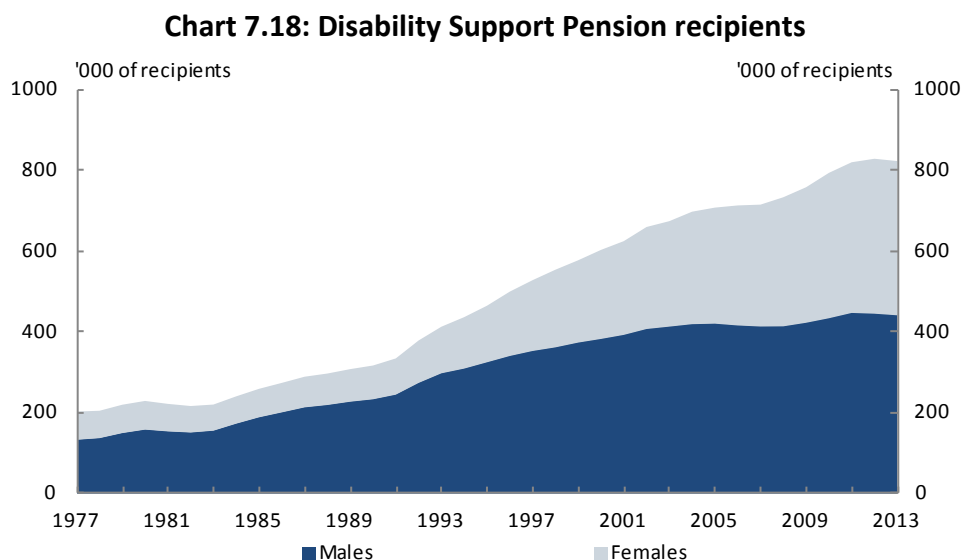
- a. establishing a 'Minimum Wage Benchmark', set at 44 per cent of Average Weekly Earnings;
- b. transitioning to this new benchmark by indexing the current national minimum wage to grow in line with the Consumer Price Index less 1 percentage point for a period of 10 years; and
- c. transitioning the minimum wage in each State and Territory to the lower of the 'Minimum Wage Benchmark' or 44 per cent of Average Weekly Earnings in that jurisdiction by 2023, noting that should this imply a reduction in the nominal minimum wage, the wage would instead be kept constant until aligned with 44 per cent of Average Weekly Earnings in that jurisdiction.

7.12 The Disability Support Pension

The Disability Support Pension provides income support to those who are unable to work, or have limited capacity to work, due to a physical or mental disability. The ongoing provision of the Disability Support Pension is consistent with the Commission's guiding principles, especially that the government should help the truly disadvantaged.

As shown in Chart 7.18, the number of Disability Support Pension recipients has more than doubled over the last 20 years. Expenditure on this programme is now \$15.8 billion per year.

In recent years, reforms have attempted to increase the workforce participation of people on this pension and improve the eligibility criteria used to assess level of disability. Building on these reforms, the Commission considers further changes should be made to the Disability Support Pension to improve targeting to those recipients with limited capacity to work.



Source: National Commission of Audit, based on Department of Social Services data.

New disability assessment and participation criteria were introduced in 2012. However, these criteria only apply to new entrants to the scheme, creating an anomaly between new and existing recipients.

Revised impairment tables used for assessing the level of disability of applicants were introduced which are consistent with contemporary medical and rehabilitation practice and support a greater focus on functional ability. They consider what people are able to do, rather than what they cannot do and are a more appropriate mechanism for assessing capacity to work.

New participation requirements were also introduced in 2012 for Disability Support Pension recipients under age 35 who are assessed as having a partial capacity work. These recipients

are required to attend regular participation interviews and to develop participation plans. Interviews are scheduled at least every six months and are to identify suitable activities for the Disability Support Pension recipient, that takes into account their individual circumstances and barriers to participation.

As only new entrants are assessed under the newer methodology there have been inequalities created between recent Disability Support Pension entrants and the existing group of people receiving this pension (that is, grandfathered recipients). The Commission considers that this anomaly should be addressed by applying the new methodology in a targeted way to some recipients of the Disability Support Pension who are currently grandfathered.

A risk management approach should be taken where application of the new criteria is applied to cohorts of grandfathered recipients who have the greatest potential for work. Examples could include younger people under the age of 35 and recipients who currently earn some employment income.

The payment parameters for the Disability Support Pension are currently equal to those for the Age Pension. It is appropriate to maintain the linkages between the Age Pension and other pension types including the Disability Support Pension. The pension class of payments represents the social living wage paid to those who are not expected to support themselves through paid employment.

Recommendations relating to changes in the Age Pension benchmark and eligibility parameters outlined in Section 7.1 will flow through to the Disability Support Pension. In particular, transitioning the Disability Support Pension to the new benchmark of 28 per cent of Average Weekly Earnings should apply at the same time as implementation of those changes to the Age Pension benchmark.

It would be a matter for Government to decide when the eligibility changes should apply to Disability Support Pension recipients (recognising that for the Age Pension these eligibility requirements apply prospectively to new recipients from 2027-28). These changes include a more comprehensive means test; and an increase in the income test taper rate from 50 per cent to 75 per cent. The Commission notes however that only a small number of recipients of the Disability Support Pension (less than 10 per cent) would likely be affected by changes to the means test.

Recommendation 29: The Disability Support Pension

The Disability Support Pension provides support to those who are unable to work, or have limited capacity to work.

The Commission recommends the Disability Support Pension be maintained as an essential part of Australia's social safety net but that changes be made to ensure it remains targeted to those in genuine need by:

- a. moving to gradually apply the new disability assessment and participation criteria, introduced in January 2012, to targeted groups of grandfathered Disability Support Pension recipients such as those under the age of 35 and those with some work capacity; and
- b. changing Disability Support Pension arrangements to align with the Commission's recommended changes to the Age Pension by:
 - i. transitioning to a new benchmark of 28 per cent of Average Weekly Earnings at the same time as implementation of the Age Pension benchmark changes; and
 - ii. the Government considering when further changes should be made to the eligibility requirements for the Disability Support Pension, including replacing the current income and assets tests with a single comprehensive means test; including the value of the principal residence above thresholds of \$750,000 for coupled pensioners and \$500,000 for single pensioners in the new means test; and increasing the income test withdrawal (taper) rate from 50 per cent to 75 per cent.

7.13 Higher education arrangements

Commonwealth funding of higher education promotes quality, equity of access and national consistency for higher education. This, in turn, contributes to a more skilled, flexible and productive workforce, with higher wages and lower unemployment resulting in higher tax revenues, reduced unemployment costs and improved international competitiveness.

Total funding from the Commonwealth Government to universities in 2012 was nearly \$15 billion, including payments under the Higher Education Loan Programme (HELP), a student loan scheme.

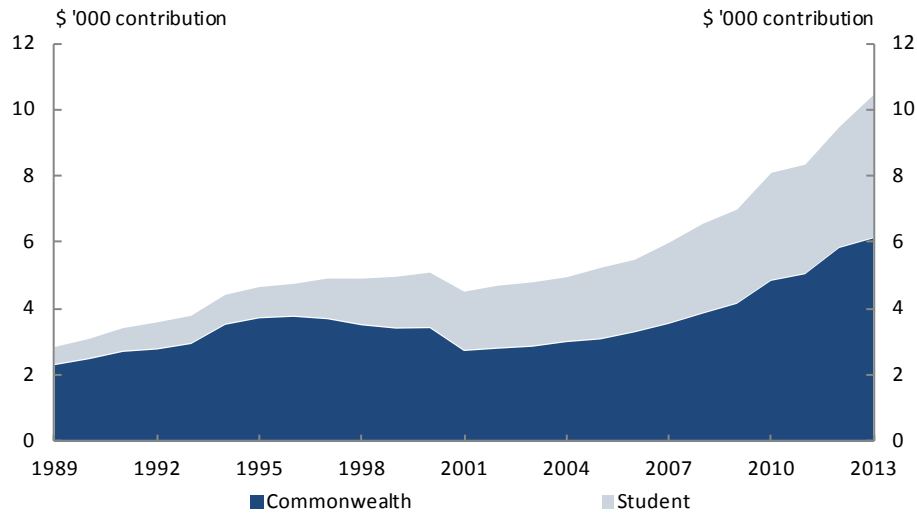
A large proportion of the benefits of higher education accrue directly to the individual students, through improved employment prospects and higher lifetime incomes. Research indicates that, compared to a year 12 graduate, someone with a bachelor qualification can expect to earn \$430,000 more over their lifetime (in current dollars). This suggests there is scope to increase the amount paid by students toward the cost of their tuition.

Chart 7.19 shows the Commonwealth currently pays around 60 per cent of domestic bachelor degree tuition costs while students only cover around 40 per cent (with 87 per cent of students deferring their student contribution through a government-supported student loan).

The Commission considers that a rebalancing of the public and private contributions to higher education costs is warranted, reflecting the substantial private benefits that arise from higher education. At the aggregate level, the proportion of Commonwealth funding should fall to 45 per cent of domestic bachelor degree tuition costs, while students would be required to cover 55 per cent of the costs.

The strong growth in total costs in recent years reflects the deregulation of bachelor degree places from 2012. The intent of this change was to provide universities with flexibility in responding to demand in setting the number of students in different bachelor degree courses. More recent preliminary data shows a slowing in this initial growth rate, as universities settle into the new system.

Chart 7.19: Commonwealth and student contributions to the tuition cost of higher education



Source: Department of Education.

While the Commonwealth has removed the cap on the number of students which universities can admit, it still regulates both the level of public contributions to universities and the maximum fees which universities can charge for different courses (with students' private contributions forming the difference between these two set amounts).

It is expected that the Review of the Demand Driven Funding System that is currently underway will give further consideration to the appropriate level for fee caps.

A number of universities lodged submissions with the Commission proposing the complete uncapping of fees.

Allowing universities to determine their own prices should improve efficiency through the operation of competitive forces. A range of prices should arise based on the quality of service offered by each university in each field of study.

Increased competition within the university sector would drive innovation and quality improvements for Australian students.

This is an area where the Commission considers further work is required. While an increase in competition in the Australian higher education market would yield improved outcomes for students, there are questions around whether market forces in Australia are sufficiently strong to yield distinct price differentiation between different courses and universities.

The Commission considers that changes should be made to the existing HELP arrangements. At present, student contributions to the cost of university education can be paid up-front or deferred by taking out an income contingent HELP loan from the Commonwealth.

HELP loans allow students to spread the costs of their education over their working lives.

However, the current design of HELP loans passes on additional costs to the Commonwealth including through the provision of concessional interest rates, the existence of bad and doubtful debts, and duplication and complexity in the existing system.

Outstanding HELP loans are indexed by CPI each year. The fact that the interest rate on these loans is below the Commonwealth government borrowing rate means that an 'additional' subsidy is provided to students equal to the difference in these rates. To better reflect the true cost of these loans to the Commonwealth, the interest rate should be increased to a level which reflects all its costs in making the loan.

Changes to HELP repayment arrangements should also be implemented to reduce write-offs for bad and doubtful debts. The Commonwealth currently expenses some 17 per cent of HELP Loans per year (or around \$1 billion) in anticipation of write-downs for bad and doubtful debts (including HELP exemptions for teachers and nurses).

At present repayments commence when taxable income reaches \$51,309 per year (which is around the average salary for Australian graduates).

The minimum HELP repayment threshold could be reduced to be equal to the minimum wage (currently \$32,354 per year), with a low repayment rate of 2.5 per cent of income. The rate of repayment would then increase with income until it matched the current initial repayment rate of 4 per cent at an income of \$51,309 per year.

The arrangements under which the repayment threshold is indexed (currently to Average Weekly Earnings) should also be changed to instead reflect movements in the CPI.

To reduce administrative overheads and ensure consistency, the five current HELP schemes should be streamlined, including removing SA-HELP.

SA-HELP is a Commonwealth funded student loan scheme to cover student amenity fees which are currently around \$273. It is simply not cost effective or administratively efficient for the Commonwealth to provide a loan scheme — potentially to be repaid after a period of years — to cover an amount of \$273.

There is also some 'leakage' of HELP repayments because debtors who move overseas are not under any legal obligation to repay their HELP loans. Implementation of arrangements to enforce repayment of HELP loans by people outside of Australia would require a change of policy and legislation and would be administratively difficult and costly.

Under the current system, the Commonwealth also loses out when HELP payments are deferred by students living overseas. However, under the Commission's recommendation to increase the rate of interest on HELP debts to reflect the full cost of loans including provisions for bad debts, the Commonwealth will no longer be worse off if HELP repayments are pushed back by a number of years. Students' HELP payments will continue to grow in

real terms in their absence, giving them an incentive to make payments even while overseas.

The Commission has considered the option of selling the Commonwealth's book of student loans to the private sector (or 'securitising' the HELP debt). Under a securitisation arrangement the current stock of outstanding student loans would be sold to private investors backed by the cash flow, including both principal and interest, from the HELP loans.

The Commission considers that HELP loans are unlikely to be a good risk-adjusted investment option for the private sector.

Currently HELP loans are valued on the Commonwealth balance sheet at around \$22 billion. Unless an investor was willing to pay at least this amount, any sale would result in a deterioration in the Commonwealth's balance sheet position.

The Commission is aware of analysis that suggests that government could expect to receive around \$12 to \$13 billion from the securitisation of this debt. It is therefore likely that securitising HELP loans would either yield a sale price less than the current book value or require an ongoing subsidy to investors to increase their return.

Moreover the Australian Taxation Office would still be required to administer and collect the HELP debt. Securitising the HELP debt would also reduce the flexibility of future governments to undertake further reforms of the student loan arrangements.

Recommendation 30: Higher education arrangements

Commonwealth funding of higher education promotes quality and equity of access, while contributing to a more skilled and productive workforce. The Commission recommends a number of changes be made to existing arrangements to better account for the private benefits of higher education and improve performance of the sector including:

- a. decreasing the average proportion of higher education costs paid by the Commonwealth through the Commonwealth Grants Scheme from 59 per cent to 45 per cent and increasing the average proportion of costs paid by students from 41 per cent to 55 per cent;
- b. tasking the Minister for Education with developing options to increase competition in Australia's education system through a partial or full deregulation of fees for bachelor degrees, taking into account any relevant recommendations of the Review of the Demand Driven Funding System. The Minister should report to the Prime Minister in 12 months' time on progress and a preferred way forward;
- c. reducing the cost to the Commonwealth of the Higher Education Loan Programme by:
 - i. increasing the interest rate applying to HELP loans from the current rate (equal to movements in the CPI) to a rate which reflects the full cost to the Commonwealth of making the loan (incorporating the government borrowing rate, as well as the cost of bad debts and administration costs);
 - ii. increasing the repayment of HELP debt through reducing the threshold for HELP repayment from \$51,309 per year to the minimum wage of \$32,354 (with a low starting repayment rate of only 2.5 per cent);
 - iii. changing the indexation arrangements for the HELP repayment income threshold from movement in Average Weekly Earnings to movements in the CPI); and
 - iv. streamlining the five current HELP schemes, including removing SA-HELP and aligning administrative fee arrangements and incentive payments for early repayment.

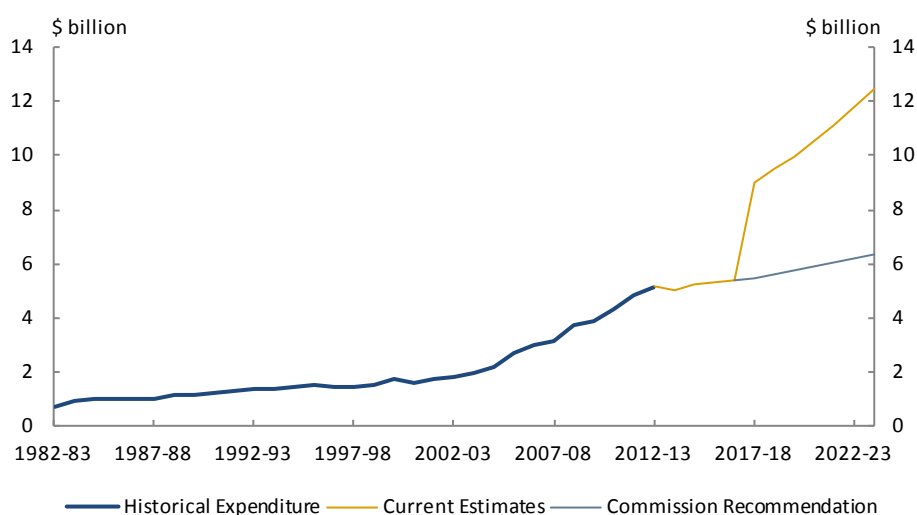
7.14 Reforming foreign aid

Australia's overseas aid programme has been managed with the objective of assisting developing countries to reduce poverty. This has been seen as serving Australia's national interests by promoting stability and prosperity both in our region and beyond.

Over the last six years, Australia's aid spending was provided in a fixed envelope based on the OECD definition of official development assistance. It had grown each year towards the previous Government's target of 0.5 per cent of Gross National Income.

As outlined in Chart 7.20 Australia's official development assistance currently stands at around \$5.0 billion and, should the previous Government's target be met by 2017-18, assistance would reach \$9 billion with foreign aid continuing to grow very strongly after that.

Chart 7.20: Growth in aid spending



Source: AusAID, Department of Finance and National Commission of Audit.

The Government's decisions to reduce funding to the aid programme across the forward estimates and merge AusAID into the Department of Foreign Affairs and Trade should assist in re-setting an agenda for Australia's aid programme.

The *Independent Review of Aid Effectiveness 2011* made a number of recommendations that the Commission considers warrant full implementation. Its key issues included:

- The aid programme lacks a clear and comprehensive overall strategy. This risks a scattered effort and makes an assessment of effectiveness difficult.
- The aid programme is fragmented. Australia has aid programmes of more than \$200,000 per year in 88 countries, compared to 69 countries five years ago. The number of projects has doubled. These trends are unsustainable. Consolidation of individual programmes and projects is needed.

- AusAID had strengthened its performance management systems in the recent past, but an important gap is the absence of a single, easily comprehensible scorecard on the effectiveness of the Australian aid programme as a whole. The system of independent evaluations is not working well and requires reform.
- A feature over the past five years has been a dramatic rise in the proportion of the aid programme going through multilateral, non-government organisations and government partners. In 2005, over 40 per cent of aid from AusAID was spent through contractors; now it is just over 20 per cent. In several respects this shift has been highly successful, but there is scope to make better use of existing partnerships and include new partners, particularly the private sector and community groups.
- A wide range of government agencies are involved in delivering aid. Other government departments bring a variety of strengths and skills and more emphasis needs to be given to whole-of-government coordination and performance management.

Aid funding had been managed to a set of targets which reflected the previous Government's agreed growth path, with unallocated funding held in the Contingency Reserve. The approach allowed for growth to be reflected in the Budget bottom line, but generated an undue focus on what was defined as official development assistance in government agencies.

The Commission considers that an artificial target for aid spending, such as 0.5 per cent of Gross National Income, has the potential to distort the focus of decision-making away from the quality of outcomes with a focus instead on the quantity of resources applied. This approach is unlikely to deliver effective programme outcomes.

The Commission therefore suggests that future aid spending should increase at a rate no greater than the rate of inflation. Even with this funding, aid spending would be at historically high levels (Chart 7.20 refers).

Over the last six years, AusAID public service staffing has grown by 126 per cent (an increase of 907 ongoing staff from 30 June 2007). Many of these staff were employed in anticipation of future increases in aid spending, which will not now eventuate.

The Commission further notes that the Independent Review argued that the objective of the aid programme should clearly focus on reducing poverty, with national interest as a subsidiary guiding consideration. The current Government, however, has indicated that it would prefer the aid programme to directly support Australia's national interest. A programme narrowly focussed on the most strategically important countries would be more sustainable.

The Government should articulate the relationship between aid spending and its strategic and diplomatic priorities. As noted above, the aid programme has had a significant level of

fragmentation, with programmes operating in many countries at small scale. This risks having programmes that lack the scale to make any meaningful progress on poverty.

Better use of aid would be to focus on the nearby countries where Australia's expertise and interests are higher, with contributions to the better performing multilateral funds (including the World Bank and the Asian Development Bank) to address humanitarian concerns beyond this region.

While AusAID has been merged into the Department of Foreign Affairs and Trade, a higher level of transparency around aid spending is still highly desirable. This can be achieved by continuing to provide an annual ministerial statement on aid spending which articulates what aid funding is used for. AusAID made some useful progress with providing for independent review of aid programmes through the Office of Development Effectiveness and the Independent Evaluation Committee.

In order to reinforce the independence and credibility of this process, the Office of Development Effectiveness should be separated from Department of Foreign Affairs and Trade and become a unit within another agency.

Recommendation 31: Reforming foreign aid

Australia's overseas aid programme serves Australia's national interests, including by contributing to global efforts to reduce poverty and promoting stability and prosperity in our region. The Commission recommends Australia's Official Development Assistance programme be better managed including by:

- a. not tying aid spending to the level of Gross National Income, rather managing it in the same way as other agency funding, with any increase in resources justified in terms of the overall fiscal context rather than to a set of funding targets;
- b. increasing future aid spending at a rate no greater than the rate of inflation, noting that even with this funding, aid spending would be at historically high levels;
- c. reducing the significant fragmentation, with bilateral aid delivery tightly focussed on countries of strategic interest to Australia and with assistance to other countries addressed through the better performing multilateral funds; and
- d. focusing aid programme reporting on outcomes achieved rather than the quantity of resources applied.

8 – Other programmes and spending

The Commission has been asked to ensure taxpayers are receiving value for money by presenting options to eliminate wasteful spending and improve the overall efficiency and effectiveness with which government services and policy advice are delivered.

The previous chapter examined the largest and fastest growing areas of Commonwealth spending. This chapter outlines further opportunities to improve efficiency including through rationalising and streamlining existing programmes.

In considering these opportunities the Commission's common sense principles from Chapter One have been framed through six interconnected tests to provide a conceptual framework to assist with a rationalisation and streamlining of programmes. The framework is not dissimilar to the approach taken by the previous Commission of Audit and other budget review exercises undertaken overseas including in Canada.

This framework considers the following six questions:

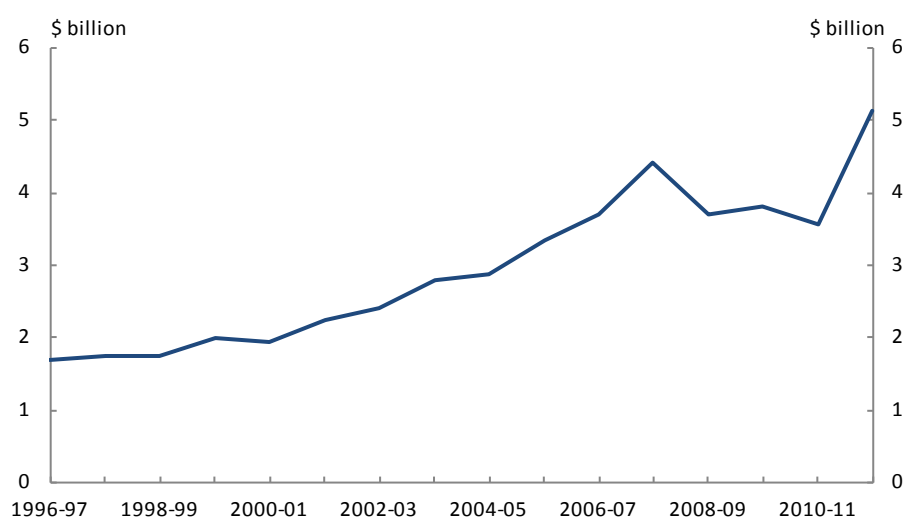
1. Does the programme or activity serve a public interest and how has it performed against its target outcome?
2. Is there a legitimate and necessary role for government in this programme or activity?
3. Is the current role of the Commonwealth appropriate or is the programme a candidate for realignment within the Federation?
4. Can the programme or activities within it be transferred in whole or in part to the private sector or the not-for-profit sector?
5. If the programme or activity continues, could its efficiency be improved?
6. Is the programme an affordable priority within the fiscal environment?

The Commission has identified a number of areas where the Commonwealth spends money on activities where there is limited justification for continued involvement or for maintaining involvement in the present form.

8.1 Industry assistance

Commonwealth Government assistance to industry is considerable. According to the Productivity Commission, in 2011-12 budgetary assistance totalled \$5.1 billion and takes various forms.

Chart 8.1: Budgetary assistance to Industry



Source: Productivity Commission.

Despite the large amount of money being spent, Commonwealth industry assistance is currently provided on an ad hoc basis. There is a range of programmes across multiple portfolios with differing goals, transmission mechanisms and levels of effective assistance. In many cases, the benefits of industry assistance accrue entirely or largely to the firm or industry supported, favouring one firm or industry over others.

The shortcomings associated with governments 'picking winners' are well known. Rather than relying on taxpayer support, market competition provides powerful incentives for firms to improve the quality of goods or services to meet consumer demands.

As outlined in Chapter Two, governments have an important role to play in setting the right environment for market competition to flourish. This includes creating a stable macroeconomic environment and pursuing microeconomic reform by eliminating unnecessary regulation, promoting more flexible labour laws and an efficient and competitive tax system.

A reduction of budgetary assistance to industry, which in most cases benefits a small number of firms, should be accompanied by a renewed commitment to broader reforms which will improve the operating environment for all businesses.

The Commission considers that:

- assistance should be well designed and targeted and be limited to areas of genuine market failure, where the benefits of government intervention clearly outweigh the costs;
- the activity should be undertaken by the most appropriate level of Australian government – whether by the Commonwealth Government or a lower level of government, to avoid duplication; and

- consideration should be given as to whether part or all of the cost of a government activity should be recouped directly from the beneficiaries of that activity.

This approach recognises that there may be a role for government in providing industry assistance where the market genuinely fails to produce the best outcomes, such as:

- encouraging research and development where the benefits clearly outweigh the costs and there are likely to be significant spillovers for the broader community;
- providing structural adjustment assistance in some situations, for example, to help workers adjust to a major dislocation caused by the closure or downsizing of a major employer; and
- intervening when there are clear externalities and where government can do so at less cost than the directly affected parties.

Consideration should also be given to either abolishing or merging all industry assistance programmes with a budget impact of less than \$5 million per year. This would result in a reduction of departmental costs.

The Commission considered industry assistance programmes against the guidelines outlined above and, as shown in Table 8.1, proposes that 22 be rationalised, phased-out, abolished or have their funding reduced.

Further information on these programmes is outlined in Section 10.1 of the Appendix to this report.

Table 8.1: Industry assistance recommendations

Programme name	Abolish	Merge	Reduce Funding	Other
Specific firm or industry assistance				
Automotive Transformation Scheme	✓			
Ethanol production subsidies	✓			
Rural Financial Counselling Service	✓			
Enterprise Solutions Program	✓			
GM Holden grant	✓			
Cadbury Factory funding	✓			
Steel Transformation Plan	✓			
Clean Energy Finance Corporation	✓			
Service available from private sector				
Small Business Advisory Services Program	✓			
Enterprise Connect	✓			
Commercialisation Australia	✓			
Mix of public and private benefits				
Screen Australia		✓	✓	
National Landcare Programme			✓	
Murray-Darling Basin water recovery				✓
State responsibilities				
Bass Strait Passenger Vehicle Equalisation	✓			
Tasmanian Freight Equalisation Scheme	✓			
Assistance to exporters				
Austrade		✓	✓	
EFIC	✓			
Export Market Development Grants Scheme	✓			
Asian Business Engagement Plan Grants	✓			
Tourism Australia			✓	
'Tourism Quality' grants	✓			
Total programmes: 22	17	2	4	1

Source: National Commission of Audit.

There are also a number of research and development programmes that assist industry. Research and development assistance is detailed in Section 8.2. Drought assistance is addressed in Section 8.5.

The Commission has identified a number of programmes where there is no genuine market failure and where benefits accrue entirely or largely to the firm or industry supported.

These include: the Automotive Transformation Scheme, the Steel Transformation Plan, ethanol production subsidies, the Rural Financial Counselling Service, Enterprise Solutions, the Clean Energy Finance Corporation and specific funding to GM Holden and the Cadbury factory in Tasmania.

Other programmes which should be abolished under this category include schemes which currently fund services that are, or could be, readily provided by the private sector without government intervention, including Enterprise Connect, Commercialisation Australia and Small Business Advisory Services.

The Commonwealth also funds a number of bodies and programmes intended to assist Australian exporters. These include the Australian Trade Commission (Austrade), the Export Finance and Insurance Corporation (EFIC), the Export Market Development Grants scheme, the Asian Business Engagement Plan Grants and support for the tourism sector.

In the time since these organisations and programmes were founded, there have been significant changes in the international environment, greater availability of information (notably through the internet), an increased maturity of the financial services sector and greater accessibility to professional services firms on a global basis.

As noted by the Productivity Commission, virtually all of Australia's exports by volume and value take place without EFIC's assistance. Support provided by EFIC has mostly been directed at a small number of large businesses, including major resource projects.

There is no convincing evidence of systemic failures in financial markets that impede their access to finance. In recent years EFIC has earned most of its income through the investment of surplus funds and its capital and reserves, not the provision of financial services.

The Commission considers that EFIC should be abolished as there is little evidence of genuine market failure in the provision of export finance.

In 2011-12 Austrade was provided with funding of approximately \$335 million. Austrade's annual report indicates that in that year, its assistance led to 205 export sales 'either under negotiation or concluded'. This does not appear to represent value for money with relatively high costs for the number of business opportunities generated. The return on investment is poor.

The Commission considers that any residual functions of Austrade such as ongoing trade facilitation should be incorporated into a commercial arm of the Department of Foreign Affairs and Trade. This will allow a greater focus on trade facilitation and diplomacy within the Department and reduce duplication of corporate services and other overheads. The existing loan book of EFIC should also be transferred to the Department of Foreign Affairs and Trade to investigate options to on-sell or wind up the loans. Other reforms to Australia's foreign affairs arrangements are outlined in Section 8.4.

The Export Market Development Grants scheme, administered by Austrade, reimburses small businesses for up to half of their international marketing costs, including for consultants, marketing visits and promotional material. The previous National Commission of Audit argued that the scheme should be abolished as the benefits of success are able to be captured by the business itself without other benefits to the community.

Popular as the scheme is, there is unlikely to be a significant spillover effect from the Export Market Development Grants scheme, as little economy-wide learning is promoted. Changes in the international environment mean that businesses have more experience and more opportunities for international marketing and therefore less need for government assistance. Austrade's 2011-12 Annual Report stated that 38.7 per cent of Export Market Development Grant recipients during the previous financial year employed four people or less.

Similarly, the Asian Business Engagement Plan provides funding to assist member-based business organisations to harness commercial opportunities in Asia for small to medium sized Australian businesses, with the benefits then accruing to business members of the organisations. There are minimal broader spillover effects outside of these business members.

Approximately \$185 million of Commonwealth funding is directed towards tourism initiatives and management. Most of this funding is for Tourism Australia, although other programmes now administered by Austrade include 'Tourism Quality' grants and the Tourism Industry Regional Development Fund. The Department of Foreign Affairs and Trade is responsible for tourism policy.

Nearly two thirds of Tourism Australia's budget is directed to advertising and other promotional activities. While tourism is one of Australia's main exports, most of the benefits of tourism accrue to the tourism operators. There is no clear reason why significant funding should be provided to tourism above other Australian export industries.

The States already provide a marketing budget for tourism. However, it is arguable that marketing Australia as a destination for international tourists should be undertaken at a Commonwealth level rather than on a State-by-State level. The Commission proposes that grant funding for the tourism industry be ceased, and funding for Tourism Australia be reduced by 50 per cent, to focus on international marketing, with the function incorporated into a commercial arm of the Department of Foreign Affairs and Trade.

The Commission has identified other industry assistance programmes which have a mix of public and private benefits. These programmes should continue but with reduced levels of Commonwealth funding. They include Screen Australia (where funding should be halved and focused on areas of Australian content, including those with an historical perspective that might not otherwise be funded) and the National Landcare Programme (where funding

should be halved and better aligned to the goals of the *Environment Protection and Biodiversity Conservation Act 1999*).

Commonwealth funding is also provided to meet the public benefit of recovering environmental water for the Murray-Darling Basin. Water recovery is funded through a range of different measures including buying water entitlements and funding private infrastructure that will return water to the river system.

The Commission considers that the Government should focus on maximising public benefits and achieving value for money in its water recovery, not on providing industry assistance. This means moving away from infrastructure funding, which is significantly more expensive and which provides substantial private benefits to landholders.

The Commonwealth should also refrain from providing assistance in areas where there is already a State presence. Duplication of industry assistance programmes wastes taxpayer funds.

Programmes which should be abolished because there is already State funding, or where the States are clearly responsible for the function include the Bass Strait Passenger Vehicle Equalisation Scheme and the Tasmanian Freight Equalisation Scheme.

In addition to budgetary assistance, support to industry is also provided through trade protection, such as tariffs, and through other non-tariff forms of protection, such as anti-dumping measures. In 2011-12, net tariff assistance to industry amounted to \$1.1 billion.

As noted by the Productivity Commission, Australia's current system of applying dumping fees to protect Australian producers from cheap imports 'benefits a small number of import competing firms, but imposes greater costs on the rest of the economy'.

Dumping protection should not be implemented unless the benefits to affected producers clearly exceed the costs to other industries and to Australian consumers. Introducing an improved public interest test would be a practical way of assessing the benefits and costs of dumping protection.

Recommendation 32: Industry assistance

Rather than relying on industry assistance, commercial discipline drives firms to reduce costs and improve quality to better meet customer demands. The Commission recommends significant changes be made to the approach to industry assistance in Australia including:

- a. limiting assistance to areas of genuine market failure and occasional transitional assistance to deal with genuine structural change. In all instances the benefit of government intervention must outweigh the costs;
- b. rationalising, phasing out, abolishing or reducing funding for 22 existing industry assistance programmes;
- c. amending Australia's anti-dumping system to include an improved public interest test so that dumping protection is only implemented if the benefits to the affected industry clearly exceed the costs to other industries and Australian consumers; and
- d. the Government continuing its drive to reduce the cost of doing business in Australia in such areas as labour market reform, deregulation, energy policy and provision of economic infrastructure.

Recommendation 33: Assistance to exporters

As the benefits of exporting accrue primarily to the business undertaking the activity, the Commission considers that there is scope to reduce current Commonwealth assistance for exporters by:

- a. abolishing the Export Finance and Insurance Corporation, ceasing funding for Export Market Development Grants, tourism industry grants and the Asian Business Engagement Plan, halving funding for Tourism Australia and significantly reducing the activities of the Australian Trade Commission (Austrade); and
- b. moving any residual functions of Tourism Australia and Austrade into a commercial arm of the Department of Foreign Affairs and Trade, with the existing loan book of the Export Finance and Insurance Corporation also transferred to the Department of Foreign Affairs and Trade to investigate options to on-sell or wind up the loans.

8.2 Research and development

The Commonwealth provides around \$9 billion per year in support for Australian research and innovation. Australia's research system generally performs well relative to other nations.

The Productivity Commission identified two rationales for public support of science and innovation.

The first is that governments need to fund research and development associated with their own core functions (for example research into defence technology and biosecurity concerns).

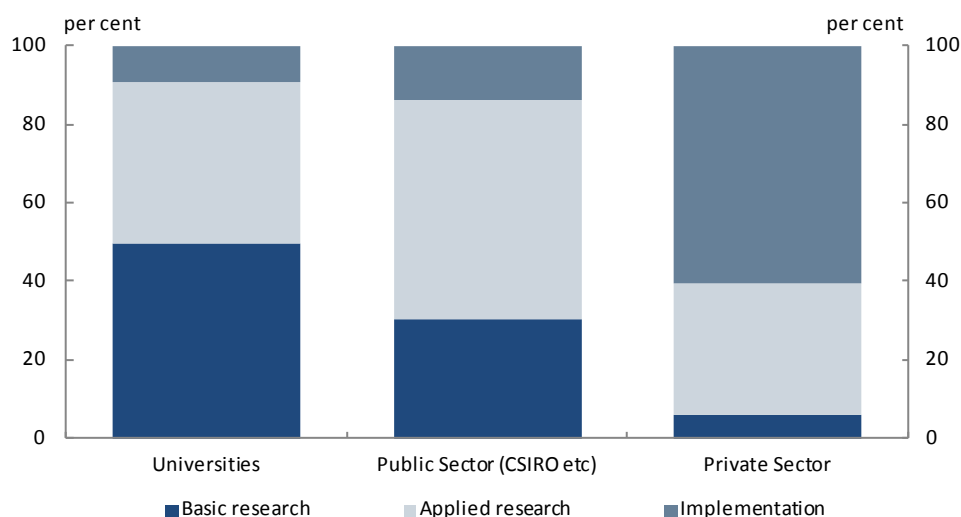
The second is because not all of the benefits from research can be captured by the innovator, with some benefits ‘spilling over’ to later researchers or adopters. These positive spillovers mean that some research that would benefit the overall economy may not be undertaken by business, as each individual business would not receive a sufficient return.

Where the benefits from capturing these spillovers clearly exceed the costs to government from intervening, there may be a role for Commonwealth support.

As shown in Chart 8.2, there are three main research sectors in Australia – universities, publicly funded research agencies (such as CSIRO and the Australian Nuclear Science and Technology Organisation) and private sector businesses. Some research, particularly in the area of health, also takes place in the not-for-profit sector.

Australia’s universities generally focus on basic research. Basic research has wider benefits and is less likely to be undertaken by the private sector. Publicly-funded research agencies tend to focus on applied research that may be used in the public or private sector. The private sector typically focuses on implementation of new ideas into products and processes in the workplace.

Chart 8.2: Commonwealth Government funding by research sector



Source: The Australian Government’s 2013-14 Science, Research and Innovation Budget Tables.

The last decade has seen strong growth in government funding for research and development, with funding growing by around 3 per cent per year in real terms. Given

overall budget constraints, it is important to take a strategic, whole-of-government approach to where Australia's research dollars are spent.

Quality research infrastructure is a critical component of Australia's research and development system and, since 2001, the Commonwealth Government has provided a series of funding programmes for large-scale research infrastructure. However, current funding for research infrastructure terminates on 30 June 2015.

Ongoing funding for critical research infrastructure in Australia could be informed by a reassessment of existing research infrastructure provision and requirements.

The Commonwealth provides direct budget funding of around \$1.8 billion per year to publicly-funded research agencies. Funding for these research agencies should be directed to those areas which are of government priority or have the highest expected spillovers.

CSIRO is by far the largest publicly funded research agency in Australia, with more than 6,500 employees. It undertakes research across a wide range of policy areas. Changing the legislative basis for CSIRO into a *Financial Management and Accountability Act 1997* body would enable the Commonwealth Government to have more visibility over CSIRO's work and ensure that resources are being directed to areas of greatest policy priority. This is the approach taken in New Zealand.

The universities sector receives around \$2.9 billion per year, most of which comes through research block grants. The universities sector also receives the majority of Australian Research Council funding each year. There is scope to streamline and better align the various different streams of funding for the direct and indirect costs of research.

The private sector receives Commonwealth support for research of around \$2.1 billion per year, most of which comes through the Research and Development Tax Incentive.

The remaining \$1.8 billion in Commonwealth funding each year can be accessed by researchers across different sectors. This includes funding from programmes such as the National Health and Medical Research Centre and Cooperative Research Centres.

There are also some 150 other minor research funding programmes and agreements across various Commonwealth agencies and departments, ranging from research into wind forecasting capability to national acoustics laboratories.

A reduction in duplication of administrative support and processes could be achieved by better aligning research programmes to the Government's policy priorities, targeting those areas with high spillovers, and consolidating a range of other programmes.

Aligning the Australian Research Council and National Health and Medical Research Centre grant processes (but keeping the entities separate) would reduce administrative costs to the Commonwealth and should also decrease the cost to researchers of applying for grants.

A significant amount of firm and sector-specific research is supported by measures such as the Research and Development tax concession. Specific grant programmes in addition to this support have the potential to skew investment decisions.

The Commission considers that sector-specific grants (such as those through the Australian Renewable Energy Agency, National Low Emissions Coal initiative, Carbon Capture and Storage Flagships and the Innovation Investment Fund) should be abolished.

There is an array of Rural Research and Development Corporations in the Agriculture Portfolio which are co-funded by industry (through a compulsory levy administered by the Commonwealth) and by government. These Corporations do not receive the benefits of the research and development tax incentive.

In return for the government contribution, the Rural Research and Development Corporations are expected to fund some research that has broader public good objectives. The wider industry and community have access to the outcomes and benefits of the Rural Research and Development Corporations' research in order to maximise spillovers.

Changes to the current funding model, consistent with Productivity Commission recommendations, would reduce the amount of government funding and better reflect the mix of private and public benefits. In particular, the current cap on dollar for dollar matching of industry contributions by government (currently set at 0.5 per cent of gross value of production) should be halved over a 10 year period.

A new uncapped subsidy at the rate of 20 cents in the dollar should be introduced for industry contributions above the level that attracts dollar for dollar matching. Duplication of administrative support and processes should be reduced by aligning 'backroom' processes across the various Rural Research and Development Corporations.

Collaboration between the different sectors of Australia's research system is crucial. For example, universities, not-for-profit organisations and the private sector collaborate in health research and development. There are inherent incentives for public and private sector researchers to collaborate to share funding, knowledge and intellectual property, so government should play a targeted role in this space.

Currently there is a range of programmes designed to encourage collaboration between universities and the private sector. Given that all of these programmes have the same objective, there would be efficiency benefits in consolidating them.

Cooperative Research Centres should be abolished, with funding rolled into the Australian Research Council Linkages programme. As part of this transition, consideration should be given to allowing longer funding periods for Australian Research Council grants. The Collaborative Research Network programme — which provides funding for larger universities to collaborate with smaller, less research-intensive and regional universities —

should also be abolished, allowing researchers to determine their own collaboration priorities.

Given that the evidence base shows that industry clusters created deliberately by government rarely become independent of government funding, government should pull back from this area, abolishing the current Industry Innovation Precincts programme, including the associated Industry Collaboration Fund.

Recommendation 34: Research and development

The Commonwealth provides around \$9 billion per year to support Australian research and innovation. The Commission recommends the Government take a more strategic, whole-of-government approach to the funding of research and development, including by:

- a. abolishing sector-specific research and development programmes;
- b. reducing government support for Rural Research and Development Corporations to better reflect the mix of private and public benefits;
- c. consolidating existing research programmes aimed at fostering collaboration;
- d. aligning the Australian Research Council and the National Health and Medical Research Council grant processes;
- e. streamlining the current system of research block grants and postgraduate scholarships and looking at options for better aligning funding for the direct and indirect costs of research;
- f. committing to ongoing funding for critical research infrastructure in Australia, informed by a reassessment of existing research infrastructure provision and requirements; and
- g. allowing for more government oversight of the work of the Commonwealth Scientific and Industrial Research Organisation to ensure that resources are being directed to areas of greatest priority.

8.3 Indigenous programmes

Commonwealth and State governments all direct significant amounts of funding towards Indigenous affairs, through both mainstream and Indigenous specific programmes and services.

Despite a long history of Indigenous policies, outcomes for Indigenous people are not improving to the extent they should be. As noted in the Department of Finance's Strategic Review of Indigenous expenditure in 2010:

The history of Commonwealth policy for Indigenous Australians over the past 40 years is largely a story of good intentions, flawed policies, unrealistic assumptions, poor implementation, unintended consequences and dashed hopes.

The Commission considers there is significant scope to improve the effectiveness of Indigenous expenditure by consolidating programmes, redirecting funding to Indigenous education, reducing overlap with the States and improving accountability.

Estimated expenditure per capita for Indigenous Australians in 2010-11 was \$44,128, more than double the amount for other Australians. This is driven by the greater intensity of service use by Indigenous people and the cost of providing services in remote locations. For example, government spending per person on housing services is around four times higher for Indigenous Australians.

In 2008, the Council of Australian Governments set six specific targets to ‘close the gap’ in outcomes between Indigenous and non-Indigenous Australians. This approach seeks to set a practical framework of outcomes and performance monitoring.

The Commission notes that three of the ‘closing the gap’ outcomes are moving in a positive direction (mortality rates for children, year 12 achievement and access to early childhood education), while the life expectancy, reading, writing and numeracy and employment outcomes are not on track to be met.

Most of the areas of greatest need (education, community safety) are largely the responsibility of the States, but the Commonwealth has stepped in to make a difference. This has led to multiple programmes from both levels of government.

In Roebourne in Western Australia, with a population of 1,150, there are around 67 local service providers and over 400 programmes funded by both Commonwealth and State governments. The small town of Toomelah, in New South Wales, with only 300 people has 70 service providers.

Table 8.2: Total estimated expenditure on Indigenous Australians, 2010-11

(\$ billion)	Commonwealth	State & Territory	Total
Indigenous Specific	3.2	2.3	5.5
Mainstream	8.3	11.6	19.9
Total Expenditure	11.5	13.9	25.4

Source: Productivity Commission.

Table 8.2 highlights the split between jurisdictions with around 55 per cent of spending on Indigenous Australians made by State governments, and 45 per cent accounted for by the Commonwealth. A significant proportion of spending by the States (around one third) is

indirectly funded by the Commonwealth through national partnership agreements and other specific purpose payments.

A fundamental question for the Commission is whether Indigenous affairs should continue to be a shared responsibility between the Commonwealth and the States. As outlined in Chapter Three, areas of shared responsibility have caused confusion and created many difficulties over time, including in terms of cost shifting.

There is currently a substantial degree of overlap and duplication between the Commonwealth and States in Indigenous affairs as well as excessively bureaucratic processes and administrative arrangements.

One option to address this would be to transfer responsibility for Indigenous specific services to the States (with associated funding transfers) to clarify responsibilities and improve accountability.

However, addressing the severe disadvantage faced by Indigenous Australians has rightly been identified as a national priority by successive Commonwealth Governments. The Commission supports this view and recommends that responsibility continue to be shared. However, accountability must be improved and other inefficiencies addressed if better outcomes are to be achieved.

At the Commonwealth level, layers of programmes have built up over the years, many of which are no longer relevant, while new programmes have been introduced. There have been few examples of programmes that have been rationalised or abolished.

There are now too many disparate and fragmented Commonwealth Indigenous programmes. There is too much duplication and a creeping overlap of responsibilities between the Commonwealth and the States. There is also a critical lack of robust evidence and evaluation about the effectiveness of Indigenous programmes at all levels of government. Finally, in some essential areas, such as primary health care and early childhood education, Indigenous Australians are under-utilising available mainstream services.

Within the Department of the Prime Minister and Cabinet there now are more than 150 Indigenous programmes and activities, with total funding of approximately \$2.4 billion for 2013-14. The Commission supports the Department of the Prime Minister and Cabinet's review of Indigenous programmes.

A consolidation into six or seven programmes with identified outcomes is needed to refocus the Commonwealth's efforts on practical ways of breaking the cycle of disadvantage affecting many young Indigenous Australians.

As part of the process of consolidation, the Commission recommends that some existing funding be redirected to a new voucher programme for education and training for

Indigenous children and young people. This programme would address inter-generational disadvantage by offering comprehensive, means-tested and needs-based vouchers to Indigenous Australians to access accredited providers of early childhood learning through to primary and tertiary education and training. This would include education fees as well as other costs such as travel and boarding.

Providing educational vouchers directly to families in need will empower Indigenous Australians to make meaningful choices about their children's education. It will shift significant Commonwealth resources from programme administration directly to Indigenous families with children, providing greater access to quality education.

Over the longer term, these initiatives have the potential to increase cognitive development, language development, school readiness, employment and law and justice outcomes.

The scheme could be maintained as a fund, with any unclaimed assistance accumulating to be paid as vouchers in future years.

The Commission has undertaken a preliminary investigation and identified a number of programmes that could potentially be abolished to fund the new programme for Indigenous children and young people. While a detailed analysis should be undertaken by the Department of the Prime Minister and Cabinet, some preliminary views of the Commission are set out below.

The Commonwealth could pull back from areas of direct responsibility of the States. This would represent a significant pivot for the Commonwealth away from some areas in which it has been heavily involved, such as Indigenous housing, municipal and essential services and the National Partnership Agreement on Stronger Futures.

Funding for lower performing, or lower priority activities (such as carbon farming) could also cease. Funding from these categories of programme, as well as programmes related to early childhood, schooling, higher and vocational education could be reinvested into the new programme.

Funding for programmes that have demonstrated effectiveness should be retained. Programmes related to areas of Commonwealth responsibility such as native title and telecommunications should also be retained. Employment programmes should be retained and considered in the context of the outcomes of the review of Indigenous employment and training programmes, chaired by Mr Andrew Forrest, which is due to report in April 2014.

Similarly, there is potential to streamline and possibly rationalise the approximately 30 Indigenous bodies, advisory boards and committees currently in existence. Indigenous Business Australia and the Indigenous Land Council should be amalgamated.

Funding support for the National Congress of Australia's First Peoples should be discontinued given that it duplicates existing Indigenous representative advisory bodies. Further detail regarding the rationalisation of bodies is included in Chapter Nine.

The Government's decision to bring Indigenous affairs together in one department is a good development. However, the Department of the Prime Minister and Cabinet has not previously had a significant role in service delivery.

There would be merit in establishing an agency within the portfolio with responsibility for Commonwealth Indigenous specific programme delivery and improving coordination between Indigenous specific programmes and mainstream programmes across the Commonwealth and the States. Reflecting the recent machinery of government changes the transition to a new agency could occur over a two to three year period.

Initially, the new agency should focus heavily on the skills and training of its staff. For example it should ensure that both policy and delivery staff have relevant experience working with and in Indigenous communities.

It should also invest in a robust data and evaluation strategy to collect meaningful information about the performance of all Commonwealth Indigenous programmes.

There are likely to be significant administrative savings under this approach. The Commission recommends that all administrative savings be reinvested in the educational vouchers programme.

Stronger mechanisms also need to be introduced to ensure mainstream programmes are working effectively for Indigenous people. There should be greater engagement with Indigenous people in the design of mainstream programmes and improved reporting on outcomes for Indigenous Australians.

Recommendation 35: Indigenous programmes

Addressing the severe disadvantage faced by Indigenous Australians has rightly been a national priority of successive Commonwealth Governments. There is, however, significant scope to improve the effectiveness of Indigenous expenditure. The Commission recommends:

- a. significantly consolidating and rationalising Commonwealth Indigenous-specific programmes, bodies, committees, councils and boards, and ensuring programmes and reporting are focussed on outcomes. The existing 150 or so Commonwealth Indigenous programmes and activities should be consolidated into no more than six or seven programmes;
- b. redirecting funds from administrative savings or the termination of less effective programmes to a new means-tested and needs-based voucher programme to assist Indigenous children with the costs of attending accredited education and training from early childhood through to primary school and tertiary education, including fees, travel and boarding costs;
- c. establishing over the next two to three years a new, separate agency for Indigenous Affairs reporting to the Prime Minister, with responsibility for Commonwealth Indigenous-specific programme delivery, development of a robust evaluation strategy and coordination with mainstream and specific providers at the Commonwealth and State levels;
- d. working directly with the States to establish new bilateral agreements which clarify and delineate responsibilities between jurisdictions, are outcomes based with clearly measurable performance indicators and involve pooled funding where appropriate; and
- e. reconfiguring mainstream services to ensure they are designed and delivered in collaboration with Indigenous people, with clear reporting requirements on access by Indigenous people and associated outcomes.

8.4 Resourcing diplomacy and consular activities

The Commonwealth Government currently spends some \$1.4 billion per year on its diplomacy functions, which are the traditional responsibility of national governments. This is essentially the cost of doing business with the world.

Funding for the Department of Foreign Affairs and Trade has generally been stable in real terms for more than a decade, reflecting a mature network and no major changes to its functions.

Nonetheless, pressures are growing on the foreign affairs function reflecting the increasingly globalised nature of the world and the complexity of the relationships that result. This includes increasing trade and investment volumes, a growing relevance of free trade agreements and increasing numbers of Australians travelling abroad.

Providing consular services is a core function of the Department. In 2012-13 a total of 8.8 million Australians travelled abroad with the Department providing consular assistance to 11,900 Australians who encountered difficulty overseas.

The Commission notes that the Department is currently reviewing its Consular Strategy. A mechanism to control demand for consular services is to introduce cost recovery arrangements that extend beyond existing consular and notarial fees. The United Kingdom, for example, charges an 'attendance fee' of £130 per hour for consular assistance provided (including travel time if performed away from the consular office). Australia should consider imposing a similar cost recovery arrangement.

Opportunities also exist to cease or scale back funding for public diplomacy activities such as the Australia Network and the International Relations Grants Program. Ostensibly, these activities are intended to support Australia's international goals, but the relationship between the funded activities and these goals is not clear.

The Australia Network is broadcast to more than 46 countries in the Asia-Pacific region. It seeks to promote a positive and accurate image of Australia and build regional, cross-cultural understanding. The ABC has been awarded successive contracts to deliver this service including the most recent contract in September 2012, valued at \$223 million for 10 years. However, the Australia Network is an expensive option for meeting such diplomatic objectives given its limited outreach to a small audience. The Commission recommends that the funding directed toward the Australia Network would be better directed to other areas or returned to the Budget.

The Commission considers that there are a number of other options to improve the efficiency and effectiveness of Australia's diplomacy and consular activities. These include ending future involvements in international expositions; re-examining the need for embassies in high-cost locations; reviewing overseas conditions and allowances; greater use of arrangements to share resources overseas with like-minded countries; and regularly reviewing Australia's memberships of international organisations.

Australia is a member of a large number of international organisations. Membership and other contributions exceed \$1 billion per year, but the continuing value of these organisations is not always scrutinised. Australia should consider withdrawing from organisations that are of only peripheral strategic interest, such as the European Bank for Reconstruction and Development and the International Criminal Tribunal for the Former Yugoslavia. It should not pursue joining the African Development Bank or the International Fund for Agricultural Development.

Passport sales are a major source of revenue, but their production is also a major cost. While significant parts of the passport production have been outsourced, the current funding model is not effective in ensuring that there is a continuing improvement in efficiency, with costs escalating by nearly 20 per cent at the most recent review in 2012-13. Once the current Passport Redevelopment Project has delivered new systems, options for outsourcing the process of producing and issuing passports should be considered.

In line with the Commission's recommendations on industry assistance in Section 8.1, residual functions of Austrade, Tourism Australia and EFIC would be incorporated into the Department of Foreign Affairs and Trade.

Recommendation 36: Resourcing diplomacy and consular activities

International diplomacy is a core responsibility of national governments. The Commission recommends steps be taken to improve the cost efficiency and effectiveness of the operations of the Department of Foreign Affairs and Trade and portfolio agencies including by:

- a. ensuring the planned review of diplomatic resourcing be undertaken by an independent reviewer rather than the department, with the review re-assessing the need for embassies in high-cost locations and making greater use of arrangements to share resources overseas with like-minded countries;
- b. ending future involvement in international expositions, introducing fees for consular services, reviewing overseas conditions and allowances, rationalising Australia's memberships of international organisations and considering further outsourcing of passport production; and
- c. ceasing funding for the Australia Network and scaling back the International Relations Grants Program.

8.5 Drought assistance

The Commonwealth provides significant assistance to farmers through various drought assistance and farm finance initiatives.

In the past drought assistance involved the declaration of Exceptional Circumstances areas. For an area to be declared, it had to demonstrate that it was experiencing a rare and severe event resulting in severe downturn in farm income over a prolonged period.

As well as income support, eligible farmers were able to access interest rate subsidies from the Commonwealth. At the height of the last drought, in 2007-08, combined drought assistance payments were around \$1 billion. Although the Exceptional Circumstances

framework was not intended to be used as long-term income support, some declarations lasted for over 10 years.

In its 2009 review, the Productivity Commission found that the Exceptional Circumstances system was inequitable as it applied differential treatment to farmers inside and outside declared boundaries, and to farmers compared to non-farm businesses who also face major business risks.

A new assistance arrangement — the Farm Household Allowance — is scheduled to commence on 1 July 2014 to replace the existing Exceptional Circumstance scheme. This new allowance is an income support safety net that will be available to eligible farm families in periods of financial hardship regardless of the source of that hardship.

Separately, the previous Government introduced the Farm Finance Concessional Loans Scheme, providing \$420 million over two years to fund productivity-enhancing projects and debt restructuring. Concessional loan rates are available for the first five years of the loan. This programme is delivered by States and the Northern Territory through various delivery agencies including regional adjustment authorities.

Continuation of drought assistance can discourage drought preparedness and self-reliance. Extending assistance to all situations creating financial hardship may exacerbate this problem.

Drought and farm assistance is complex and regularly subject to review and changes. Reforms announced by the previous Government are in the process of being implemented, with substantial details yet to be announced.

Previous programmes involving interest rate subsidies were abolished and have been replaced by concessional loans. Tax concessions also available to farmers include measures to manage income variability such as income averaging and the Farm Management Deposit scheme.

The Commission recommends abolishing the concessional loan scheme. The scheme encourages farms to take on more debt, when there is little evidence to suggest that farm businesses that are viable over the longer term have difficulty accessing commercial finance.

Beyond this programme, the Commission has not undertaken a full reassessment of drought support which would involve a comprehensive look at farm assistance through the tax system and outlays.

However, the guiding principle in drought policy should be to ensure that farmers face incentives to prepare for drought and other climatic and economic conditions. Weather variations are a normal part of farming and should be incorporated into risk management practices. There may be opportunities to further consolidate drought and farm programmes.

Recommendation 37: Drought assistance

The Commonwealth provides significant assistance to farmers through various drought assistance and farm finance initiatives. The new Farm Household Allowance scheme scheduled to begin in mid 2014 will exist alongside a concessional loan scheme for farmers. The Commission recommends that the Farm Finance Concessional Loans Scheme be abolished.

8.6 Programmes that duplicate State responsibilities

Responsibility for housing affordability

There is no head of power under the Constitution for the Commonwealth in relation to housing. Housing affordability and homelessness prevention are the responsibility of State governments.

Nonetheless the Commonwealth currently has two major areas of spending on housing – the provision of Rent Assistance and payments to the States for affordable housing and alleviating homelessness.

Rent assistance payments are provided to income support recipients. More than a million renters around Australia receive Rent Assistance at a cost of around \$3.6 billion per year. Rent Assistance is not currently paid to public housing tenants.

The Commonwealth contributes approximately \$1.3 billion to the States through the National Affordable Housing Agreement. A further \$159 million is also provided through the National Partnership Agreement on Homelessness.

In addition the Commonwealth provides funding through the National Rental Affordability Scheme which seeks to address the shortage of affordable rental housing by offering financial incentives to business and community organisations to build and rent dwellings to low and moderate income households. Funding from this source is around \$1.5 billion over four years.

Various reports from the COAG Reform Council on housing and homelessness suggest that there has been limited success in delivering affordable housing and reducing the incidence of homelessness. National agreements have added complexity and increased the administrative burden to all levels of government.

The Commission considers there is a strong case for the Commonwealth to limit its involvement in this area to providing rent assistance to income support recipients and continuing to offer State governments access to the Commonwealth's one stop shop social services policy.

The Henry Tax Review outlined the case for extending Rent Assistance to public housing tenants, with these tenants paying the market rent of the dwelling. Under such an arrangement, the Commonwealth would need to increase aggregate Rent Assistance funding. However, this additional funding could be sourced from a redirection of funding currently contributed to the National Affordable Housing Agreement and the National Rental Affordability Scheme.

As noted above annual funding for these two programmes is currently around \$1.5 billion per year.

The Commission considers that there is merit in considering this option further. Two benefits would arise from this approach. First, the market would determine rents for public and private housing. Second, abolishing housing agreements with the States would remove duplication of effort, improve accountability and alleviate the reporting burden for State governments. Commonwealth funding currently directed to the housing agreements should be redirected to fund the extension of rent assistance to public housing tenants.

The Commission notes that there may also be flow-on effects to eligibility for Rent Assistance arising from its recommendations on family payments, age pension and other social welfare areas. If this option is adopted, implementation should include an examination of ways of ensuring that Rent Assistance is well targeted and delivered in the most appropriate way.

Recommendation 38: Housing assistance

Housing affordability and homelessness prevention are primarily the responsibility of State and Territory governments. The Commission recommends the Commonwealth:

- a. limit its involvement in housing to providing Rent Assistance payments;
- b. extend Rent Assistance to public housing tenants, provided State governments commence charging market rates of rent; and
- c. fund the increase in aggregate Rent Assistance payments by re-directing Commonwealth funding from existing agreements with the States for Affordable Housing and Homelessness and the National Rental Affordability Scheme.

Vocational education and training

Vocational education and training has traditionally been a State responsibility. The Commonwealth has no constitutional responsibility for vocational education and training.

The States provide 97 per cent (or \$6.4 billion per year) of government funding for vocational education and training. This includes \$1.8 billion per year of Commonwealth

money provided through the National Agreement for Skills and Workforce Development and the National Partnership on Skills Reform.

The Commonwealth directly provides only some 3 per cent (or \$0.2 billion per year) of government funding for vocational education and training. This includes around \$140 million per year for the development of skills and training through the National Workforce Development Fund. The Commonwealth also provides funding to encourage businesses to take on apprenticeships.

Given the amount of money all governments spend in the vocational education and training area, outcome achieved are not strong. For example, in 2012, the completion rate for trade apprentices was only around 56 per cent.

In recent years, the Council of Australian Governments has embarked on reforms in the vocational education and training sector aimed at lifting skills across the economy and better aligning skills to labour market demand. The reform agenda recognises that the sector must be responsive to changes in the labour market. The Commission supports the move away from a regulated and supply-driven system to a demand-driven, contestable market, as has been introduced in Victoria.

In its submission to the Commission, the Victorian Government raises concerns with the duplication arising from the Commonwealth funding its own vocational education and training programmes:

Commonwealth apprenticeships and youth transitions programs, and the National Workforce Development Fund, duplicate State training support and funding programs. This results in financial inefficiency, confusion and red tape for employers and service users, and limited opportunities to improve outcomes through a more integrated service system.

The Commonwealth's supply-driven funding does not align with, and potentially undermines, Victoria's demand driven approach. The Commonwealth and Victoria should work together to trial the consolidation of funding and programs at the State level.

The Commission believes it would make sense for the Commonwealth to pull back from its involvement in vocational education and training, with a view to providing full policy responsibility to the States.

Such an approach would require an equivalent adjustment in funding. Section 6.2 discusses opportunities to improve vertical fiscal imbalance between the Commonwealth and the States to facilitate a clarification of roles and responsibilities. Vocational education and training should be considered in this context. Alternatively, the Commonwealth could provide the States with an annual lump sum, with limited conditions, such as requiring appropriate levels of national reporting on outcomes and national quality assurance.

In terms of quality assurance, Section 9.1 recommends that the Tertiary Education Quality Standards Agency be merged with the Australian Skills Quality Authority.

The transfer of responsibility to the States should be done on the basis that the States continue to pursue reforms to ensure vocational education and training is demand-driven and responsive to industry requirements.

The transfer should also simultaneously address the need to improve Australia's occupational licensing arrangements.

At present, many occupations are licensed separately in each State, with the licence determining the work that can be performed in that jurisdiction. For many occupations, holding a licence in one State does not entitle an individual to work in another. This has long been recognised as an impediment to labour mobility in Australia. It is also an area where the Commission considers that the Federation has failed to deliver a sensible outcome for Australians over many years.

While mutual recognition of licences between States has been progressively introduced since 1992, the system remains unwieldy and ineffective. Workers seeking to have their credentials recognised in another State are often required to undertake additional training and must pay additional licence fees. It can take up to a month to receive accreditation for mutual recognition of qualifications and licensing.

In July 2008, the Council of Australian Governments agreed to establish the National Occupational Licensing System for a number of specified occupations. The intention was to ensure licences issued by any jurisdiction would be valid in all States. This approach was abandoned by the States in 2013, in favour of improving mutual recognition arrangements. It is now incumbent on the States to quickly and effectively streamline these arrangements.

Recommendation 39: Vocational education and training

Currently the States provide the vast majority of funding to the vocational education and training sector, with the Commonwealth contributing through tied grants to the States and some specific Commonwealth programmes. The Commission recommends that the Government wind back its involvement in the vocational education and training sector by:

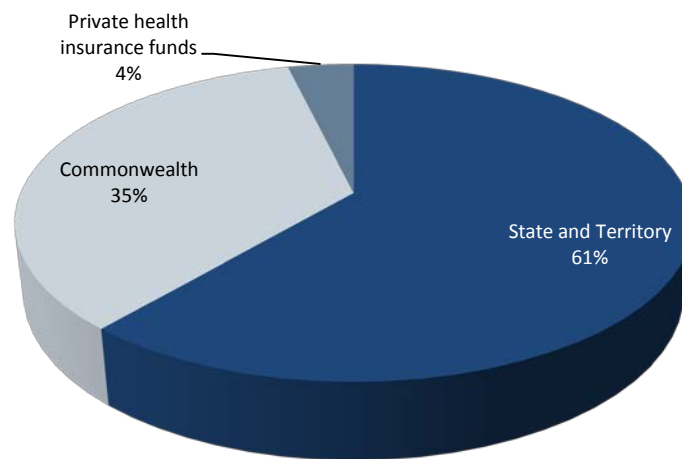
- a. transferring policy and funding responsibility for vocational education and training to the States, with Commonwealth funding to be provided either as:
 - i. a single annual lump sum with minimum requirements for national reporting and quality assurance; or
 - ii. as part of a broader reform of federal financial relations;
- b. abolishing all Commonwealth vocational education and training programmes including the National Workforce Development Fund and Commonwealth support for apprentices; and
- c. requiring the States to continue reforms to achieve demand-driven vocational education and training outcomes and improve occupational licensing arrangements.

Mental health

Since the early 1990s there has been a greater focus on mental health policy with governments at all levels consistently increasing both health and non-health expenditure.

An estimated \$6.9 billion was spent on recurrent mental health-related services during 2010-11. Of this, \$4.2 billion came from State governments, \$2.4 billion from the Commonwealth Government and \$257 million from private health insurance funds (Chart 8.3).

Chart 8.3: Funding sources for recurrent mental health-related services



Source: Australian Institute of Health and Welfare.

Commonwealth Government direct funding for mental health included Medicare-subsidised mental health-related services and subsidising over 23 million PBS prescriptions for mental health-related medications in 2011-12.

State governments fund and deliver services and assist with broader needs, such as accommodation. The largest proportion of spending was on public hospital services for admitted mental health care. Community mental health care spending and residential mental health services are also provided.

The multiple components of mental health mean that it is difficult to establish accurate and up to date expenditure information and data on mental illness is not consistently collated or sufficiently aggregated. Medicare, for example, does not disaggregate many of the mental health related services provided.

Mental illness ranges from low prevalence through to severe conditions that often co-exist with other health difficulties and social challenges. For example, over 50 per cent of people admitted to alcohol and drug treatment facilities have a history of mental illness and it is estimated that up to 80 per cent of people will visit a General Practitioner for initial assistance for their mental health condition.

The mental health system is complex and fragmented across employment, education, Indigenous programmes, aged care, welfare and the National Disability Insurance Scheme.

There are overlapping funding and service delivery responsibilities, a lack of coordination and integration of mental health and the broader social and welfare services, and the absence of information to demonstrate whether the right amount of money is being spent and in the right areas of mental health.

In September 2013 the Government announced that the National Mental Health Commission would be undertaking a national review of mental health services to ensure

that services are being properly targeted and not duplicated and that programmes are not unnecessarily burdened by red tape.

In keeping with its principles, the Commission considers that the review should identify ways to better target mental health funding for the most vulnerable and identify opportunities for coordinating and integrating mental health services with broader social and health services. The review should also examine how fragmentation in the services system and overlapping roles and service delivery responsibilities can be reduced. This should be considered in the context of broader reforms to the health system proposed in Chapter Seven.

Recommendation 40: Mental health

Mental health services are characterised by overlapping funding and service delivery responsibilities and a lack of coordination across jurisdictions.

The Commission supports the proposed review by the National Mental Health Commission and recommends that the review pay particular attention to removing the significant duplication between the Commonwealth and the States that currently exists in mental health services.

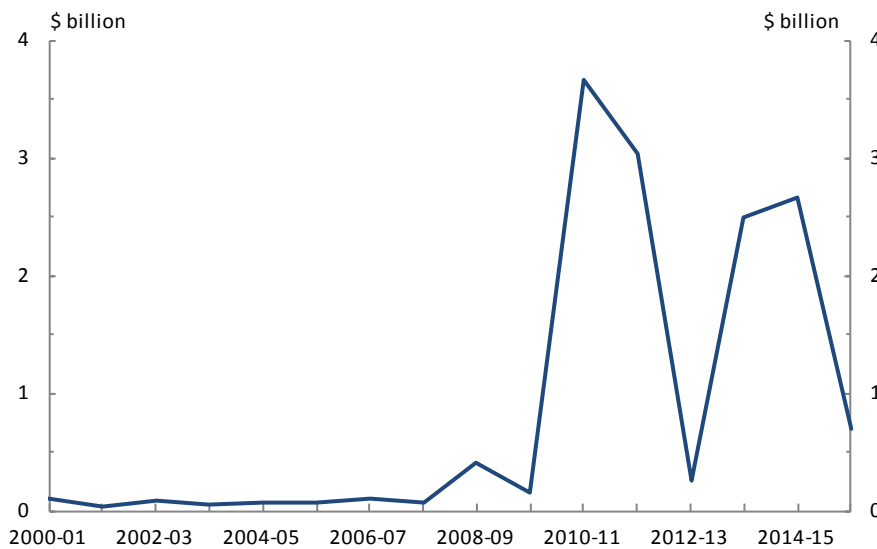
Natural disaster relief

The Commonwealth Government provides financial assistance to State, Territory and local governments, and to businesses and individuals to help them deal with the consequences of major natural disasters.

Recently, Commonwealth disaster expenditure has had a significant impact on the Budget due to major flooding events that occurred in 2010-11 and the following two years, particularly in Queensland.

Over this period the Commonwealth has contributed \$5.8 billion toward State and Territory disaster reconstruction costs and further contributions of \$5.8 billion are incorporated in the forward estimates. This large and volatile expenditure poses significant and ongoing risks to the Budget. See Chart 8.4.

Chart 8.4: Commonwealth disaster assistance to the States



Source: Department of Finance.

The Natural Disaster Relief and Recovery Arrangements is the main form of Commonwealth assistance. Funding to State and local governments is determined by the claims submitted for eligible funding and in line with a designated formula.

Consistent with the general approach taken that the Commonwealth should avoid attempting to duplicate the functions of the States, the Commission recommends that the current claims-based process be replaced by a grant arrangement to the affected State after a major natural disaster. The grant would be paid over a number of instalments.

The level of Commonwealth contribution would vary depending on the size and severity of the disaster event, but could be set at between 25 per cent and 33 per cent of likely reconstruction costs (with the amounts based on assessments by insurance expert assessors).

The Commonwealth Government also supports individuals and businesses through two mechanisms administered through Centrelink.

- The Australian Government Disaster Recovery Payment is short term, non means-tested financial assistance payment for eligible Australian residents adversely affected by a major disaster, of \$1,000 for eligible adults and \$400 for eligible children.
- The second form, the Disaster Recovery Allowance, provides short term income support to employees, small business persons and farmers who experience a loss of income as a result of a major disaster, subject to means testing. It is paid at the equivalent to the maximum rate of Newstart Allowance or Youth Allowance depending on the individual's circumstances, for up to 13 weeks.

Commonwealth support should be restricted to those that suffer severe hardship. Take-up rates for the Disaster Recovery Allowance and similar wage subsidies have typically been very low and provide poor signals to employers to undertake better business and risk planning. It is suggested that the Disaster Recovery Allowance be abolished.

Recommendation 41: Natural disaster relief

Recognising the primacy of State governments in dealing with natural disasters, Commonwealth involvement should be significantly reformed including by:

- a. replacing the Natural Disaster Relief and Recovery Arrangements with a grant in the case of each major natural disaster, with the Commonwealth contribution based on a designated proportion (between 25 per cent and 33 per cent) of the estimated reconstruction costs; and
- b. maintaining the Australian Government Disaster Recovery Payment but abolishing the Disaster Recovery Allowance with the Commonwealth's direct contributions being paid to only those individuals severely affected by natural disasters.

Community Investment Programme

The Community Investment Programme provides funding to improve the responsiveness and integration of local community services to increase the participation of vulnerable people in community life.

Total funding for the Community Investment Programme in 2013-14 is \$43.2 million. The Commonwealth Government has a long history of providing grants funding to the community sector.

There are four streams of grants funding under the Community Investment Programme.

- *Community Capacity Building Projects* – this stream provides grants to community organisations to deliver local projects to strengthen communities and assist disadvantaged individuals to participate in community life. Current funding agreements expire on 30 June 2014, except one which expires on 30 June 2015.
- *Volunteer Grants* – this stream offers ad hoc grants of between \$1,000 and \$5,000 to not-for-profit organisations to help cover the costs of volunteers, including training, fuel and any required background checks. Grants rounds are conducted on an annual basis and funding for 2013-14 is fully committed.
- *National Secretariat* – this stream provides funding for seven peak organisations to manage relationships with stakeholders and provide advice to government. Funding agreements expire on 30 June 2014, except one which expires on 30 June 2016.

- *Indigenous Community Links* – this stream supports Indigenous community members and their families by providing links and referrals to a range of mainstream and Indigenous services, such as welfare and social support, employment, legal and housing. Funding is provided for Indigenous Community Links to 2014-15.

The Commonwealth Government does not have an explicit constitutional head of power to deliver community development programmes. Community grants for development and volunteers are currently provided by at least some State governments. There is scope for the Commonwealth to transfer responsibility and funding for these programmes to the State governments.

Recommendation 42: Community Investment Programme

There is scope for the Commonwealth to transfer responsibility for community development programmes to the States and Territories, the level of government closest to the people receiving the services. The Commission recommends that the Commonwealth transfer funding and responsibility for the Community Investment Programme to the States and Territories.

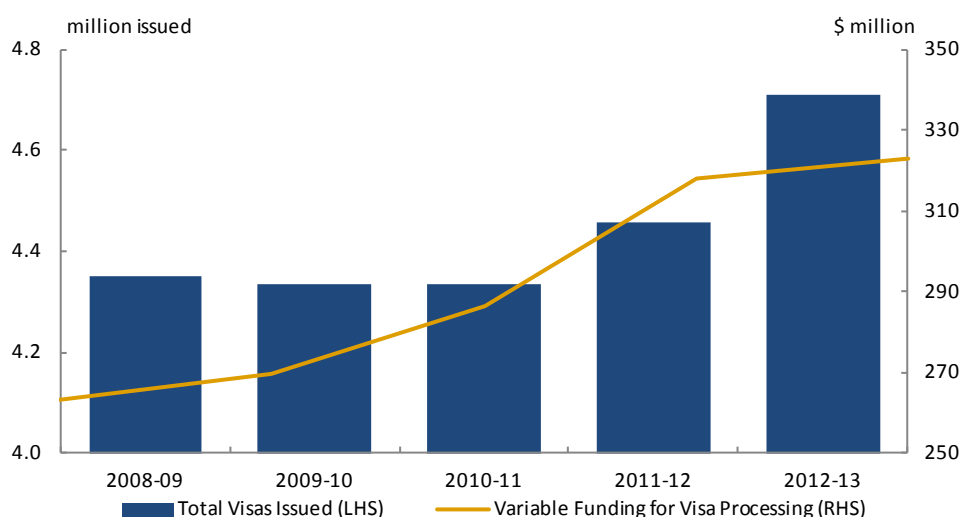
8.7 Other selected programmes

Outsourcing visa processing

The Department of Immigration and Border Protection grants around 4.7 million visas every year. The cost of handling enquiries, assisting with lodgements and reviewing applications is around \$520 million per year, while the fees generated from Visa Application Charges exceed \$1.1 billion.

The department is currently implementing a reform programme that aims to steer a greater number of visa applicants towards online and electronic visa lodgement, use greater automation to process low-risk visa applications, and expand the use of outsourcing arrangements for the operation of Australian Visa Application Centres that collect and register visa applications in a number of locations globally.

Chart 8.5: Number of Visas Issued and Variable Funding for Visa Processing



Source: Department of Finance.

Notwithstanding the efficiency gains from moving from paper to electronic lodgement, there remain a large number of functions that could potentially be done at the same or higher levels of quality at a reduced cost through outsourcing or co-sourcing arrangements.

Many tasks related to visa processing are high volume and low complexity and would be well suited to outsourcing. Examples include call centres, shop fronts, counter services, data entry, payment collection, design and operation of web sites and the processing of low and medium risk visa applications.

An outsourced arrangement could have the added advantage of avoiding periodic major capital outlays for the fit-for-purpose information technology systems necessary to support visa processing.

However, outsourcing of this function would need to be handled carefully, as not all visa related tasks are suitable for outsourcing. The high risk of fraud associated with some visa applications and the complexity required in resolving these cases require that at least a residual processing capability should be retained by the department.

That said, the Commission considers that that the potential for significant efficiency gains and service advantages warrants the development of a business case and scoping study for the outsourcing of visa processing functions. This study should identify and group functions that are suitable for outsourcing and include a strategy for approaching the market to maximise savings.

Recommendation 43: Visa processing

The Department of Immigration and Border Protection grants around 4.7 million visas every year. Many visa processing tasks are high volume and low complexity and would be well suited to outsourcing. The Commission recommends that a business case and scoping study for outsourcing the Department of Immigration and Border Protection's visa processing functions be prepared.

Employment services

The bulk of employment services are provided through Job Services Australia, which currently offers services to around 760,000 job seekers. Funding under this scheme is around \$1.3 billion per year.

The existing round of employment services contracts are due to expire in the middle of 2015. A review has been conducted with a view to making further modifications to the next round of contracts.

While the average cost per job seeker has declined since the introduction of the Job Network and then Job Services Australia, there are still concerns about whether the employment services arrangement provides the most cost effective way of getting unemployed people into work.

In particular, there is a focus on how well the arrangements work at placing the longer term unemployed. At present, around 400,000 Australians have been out of work for more than 12 months and of these 170,000 have been out of work for 36 months or more.

Substantive changes to the current employment services model do not appear to be warranted at this time. International evidence suggests that the Australian approach is seen as being at the frontier of good policy in this area. Job Services Australia and its predecessors demonstrate the benefits of using contracting arrangements compared to traditional government provision of these services.

Changes could, however, be contemplated to improve the effectiveness of the arrangements. This could include examining the case for changes to the payment structure to providers which provide greater incentive for job placement (that is, outcomes, rather than servicing).

This could result in increased payments for placing the most disadvantaged job seekers and reduced payments for placing 'job ready' job seekers. Another option would be to delay access to employment services for those job seekers who are most 'job ready' on the grounds that they require the least assistance.

Employment services are also supported by wage subsidies, including the Wage Connect programme. Under Wage Connect, subsidies are available to employers who take on long-term unemployed job seekers.

The subsidy is paid at the rate of \$233 per week for 26 weeks. The job seeker must have been on income support for at least two years and had limited work experience, in order for the subsidy to be available. There are 10,000 capped places per year for Wage Connect. In December 2013, the Government advised that there would be a pause on new entrants to the Wage Connect scheme as it was fully subscribed.

The effectiveness of wage subsidies is open to question, given that they may displace other job seekers or simply result in employment ceasing once the subsidy is finished.

Another issue is the average rate of subsidy under Wage Connect, which is higher than similar programmes such as the Tasmanian Jobs Program and Seniors Incentive Program.

These proposals complement recommendations on reforming unemployment benefits and the minimum wage as outlined in Section 7.11.

Recommendation 44: Employment services

The bulk of employment services are provided through Job Services Australia. The existing round of employment services contracts are due to expire in 2015. The Commission recommends the Government develop options to:

- a. improve the structure of employment services provided to the most disadvantaged jobseekers; and
- b. lower average costs per jobseeker under the post-2015 employment services arrangements, including by making greater use of technology in delivery of services.

The Commonwealth subsidy under Wage Connect is higher than similar wage subsidy programmes. The Commission recommends reducing the subsidy paid under Wage Connect to the levels available under similar programmes.

Efficiency of the public broadcasters

The national broadcasters, the Australian Broadcasting Corporation (ABC) and the Special Broadcasting Service Corporation (SBS) which includes National Indigenous Television, are both substantially funded by the Commonwealth, although funding for SBS is supplemented by commercial advertising revenue.

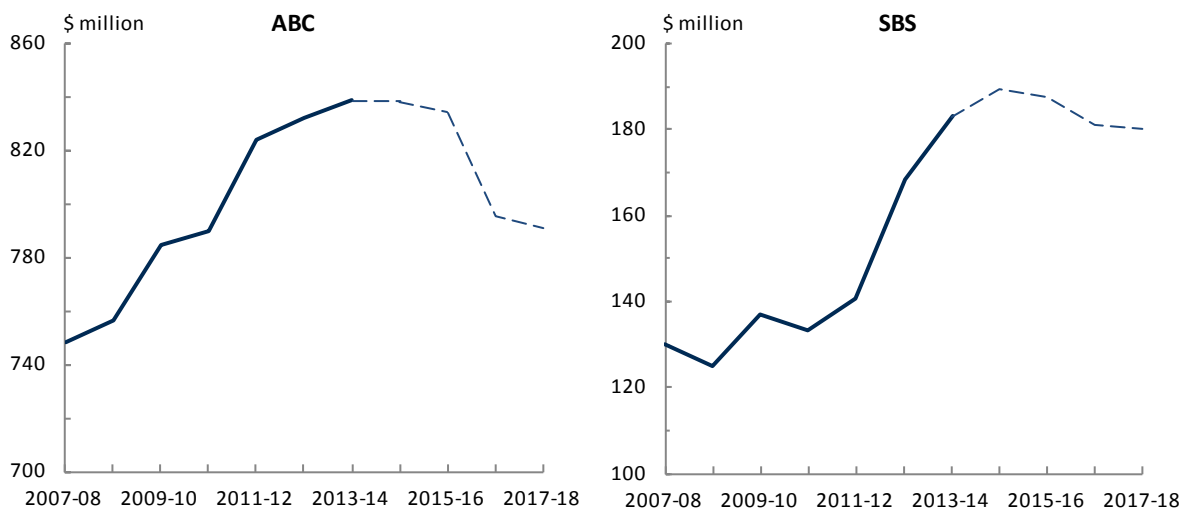
Their current annual appropriations are approximately \$1.1 billion and \$270 million respectively.

The ABC and SBS broadcast on seven distinct channels, across two 7 megahertz bands of spectrum. Their transmission services are currently provided under long-term contracts by Broadcast Australia and cost around \$200 million per year for the ABC and \$80 million for the SBS.

The ABC and SBS are both Commonwealth statutory authorities, but have a significant degree of independence from the Commonwealth. In recent years, there has been strong growth in the amount of base funding available for both organisations and they have been exempt from the efficiency dividend. See Chart 8.6.

However, both agencies face funding pressures from increasing costs of programming, increased use of on-line services, falling advertising revenue for SBS and large capital replacement costs.

Chart 8.6: Public broadcasters non-transmission funding, \$ 2012-13



Source: Mid-Year Economic and Fiscal Outlook 2013-14.

Note: The decrease in the ABC's 2016-17 funding relates to terminating measures relating to news content and digital delivery funding.

The traditional arguments for government funding of public broadcasting include the need for a form of media and content accessible by all the public, regardless of cost of provision; independence from commercial and corporate influence; and, diversity in the delivery of content for which there is no incentive for commercial broadcasters to produce or distribute.

The Commission acknowledges that there is no 'right' level of funding that should be provided to the ABC and the SBS, or 'right' level of services that should be provided by the public broadcasters.

However, it considers that both organisations have the ability to improve their efficiency and better target expenditure than may currently be the case. The case for reconsidering the level of support for the public broadcasters is underpinned by advances in technology, societal changes and an expectation of achieving efficiencies and value for money.

Media convergence, especially the availability and access of text, audio and video media via the internet, is increasingly eliminating the traditional arguments for public broadcasting. It could be argued that the need for government intervention or support has now been superseded by technology and commercial imperatives.

At present, the Government does not have a mechanism to harvest the benefits of efficiencies from the public broadcasters. Any efficiencies that are found, including through technological advances or market changes, are currently reinvested by the ABC and the SBS in their own operations. Unlike commercial broadcasters, no dividend is returned to public broadcasters' shareholders – the government and people of Australia.

Given the significant difference in the amount of funding provided to the public broadcasters, the Commission proposes that the ABC and SBS be benchmarked against each other and the commercial broadcasters. This exercise should provide a sense of the efficiency of operations and the potential savings that could be achieved without compromising the capacity of the public broadcasters to deliver services including to remote and regional Australia. Future funding decisions should be informed by the benchmarking outcome.

Recommendation 45: Efficiency of the public broadcasters

There is no right level of funding for the Australian Broadcasting Corporation and the Special Broadcasting Service as public broadcasters, or a right level of services that should be provided. However, there may be opportunities for greater efficiencies. The Commission recommends that:

- a. the ABC and SBS be independently benchmarked, both against each other and the commercial broadcasters, to determine whether it would be possible to achieve efficiencies and savings without compromising their capacity to deliver services including to remote and regional Australia; and
- b. future funding decisions in relation to the ABC and SBS should be informed by the outcome of the benchmarking exercise.

Containing costs associated with the detention of Illegal Maritime Arrivals

The detention and processing of Illegal Maritime Arrivals has been the fastest growing government programme over recent years. Between 2009-10 and 2013-14 annual expenditure has increased from \$118.4 million to \$3.3 billion.

Projected costs over the forward estimates currently exceed \$10 billion.

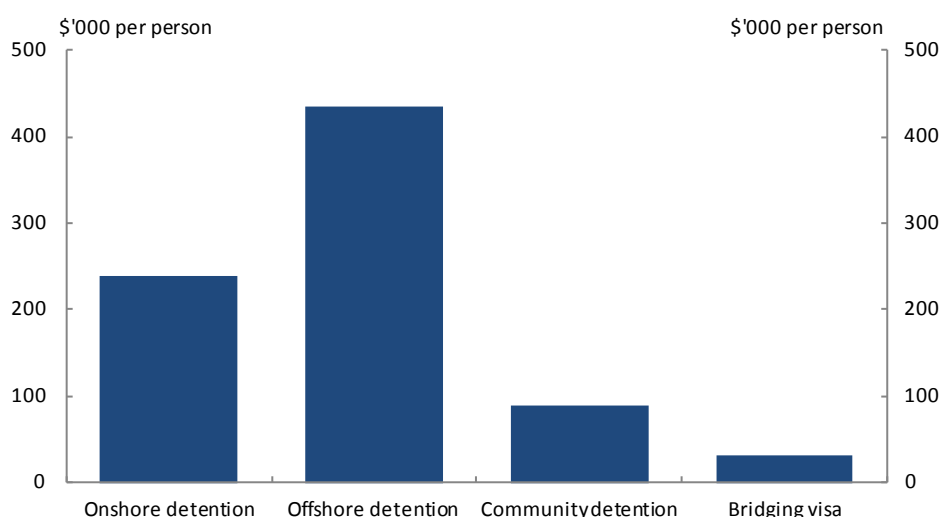
While the growth in expenditure is largely due to an increase in arrival rates, there has also been a material increase in costs associated with running the immigration detention

network. For example, estimated annual costs of holding one person in onshore detention have increased from \$179,000 in 2011-12 to \$239,000 in 2013-14.

To a significant extent this growth in costs has been due to increases in the scope of services provided under the contracts the Department of Immigration and Border Protection has in place with service providers.

The costs incurred in the delivery of this programme depend on a range of complex factors, with the major cost driver being the number of people in immigration detention, community detention or living in the community on bridging visas. This in turn is influenced by the number of Illegal Maritime Arrivals, average processing times and other policy settings. Chart 8.7 below illustrates the relative cost for each detention option.

Chart 8.7: Relative cost per person for 12 months in detention 2013



Source: Department of Finance.

These detention and processing arrangements were necessarily developed in an ad hoc fashion in response to a number of crises (including significant overcrowding, riots, fires and growing incidences of self harm), as well as the rapidly changing policy environment.

While it is unsurprising that costs have grown substantially in these circumstances, there is scope to improve efficiency and eliminate waste and to ensure that decision making recognises the need to secure cost effective outcomes.

The policy settings now in place appear to have been effective in reducing arrival rates. Arrivals have fallen from a peak of around 4,300 per month in July 2013 to around 200 per month by November 2013. If these trends continue, the Department of Immigration and Border Protection should be able to redirect its efforts away from constantly managing crises and focus on achieving better value for money across the network.

Notwithstanding the recent announcement of the closure of four detention centres, the cost of operating the onshore immigration network could be further wound back to 2011-12 levels (approximately \$179,000 per person). Savings would primarily be achieved by

renegotiating contracts and, in some cases, reductions in the services provided to people in detention.

In order to determine the appropriate level of services it may be necessary to conduct an audit of the scope and the cost of services currently being provided and how these have changed over time. This could include reviewing the roles of departmental staff and service providers with a view to removing duplication.

Should the policy settings continue to be successful in reducing arrival rates, further savings could be generated through the consolidation of the immigration detention network to achieve economies of scale – in particular through closing smaller, inefficient centres.

Recommendation 46: Containing costs associated with Illegal Maritime Arrivals

The detention and processing of Illegal Maritime Arrivals has been the fastest growing government programme over recent years. The Commission recommends that:

- a. by renegotiating contracts and better targeting of services, the per person cost of operating the onshore immigration network be reduced to 2011-12 levels and similar efficiencies be sought for the offshore network; and
- b. this process also be supported by an audit of the scope and cost of services currently being provided and how these have changed over time.

Fair Entitlements Guarantee Scheme

The Fair Entitlements Guarantee Scheme was introduced, via legislation, in late 2012 and replaced the former General Employee Entitlements and Redundancy Scheme.

Where a firm enters into liquidation and is unable to pay employee entitlements, the Fair Entitlements Guarantee Scheme provides the following payments to eligible workers:

- redundancy pay of up to 4 weeks' per full year of service;
- up to 13 weeks' unpaid wages;
- annual leave and long service leave payments; and
- payment in lieu of notice – up to 5 weeks.

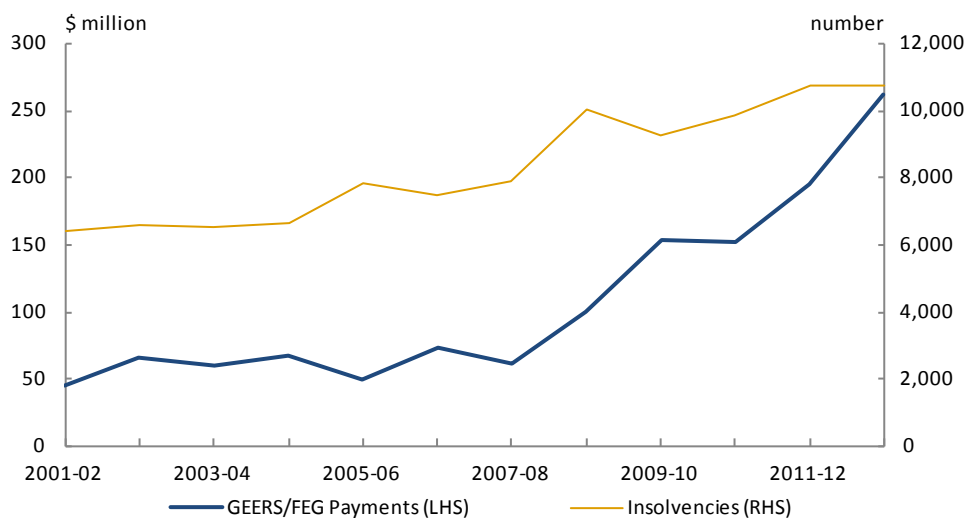
The Fair Entitlements Guarantee Scheme increased the level of generosity in payments from the General Employee Entitlements and Redundancy Scheme, particularly in relation to the uncapping of redundancy pay. The previous cap was 16 weeks, but is now effectively unlimited.

One concern with the design of the scheme is that it may reduce the incentive for companies to guard against risk of insolvency because they are partly protected from the consequences by the government. It could be argued that with the government picking up the costs for a major portion of all redundancy entitlements, companies have less incentive to worry about this aspect of costs if they are in a marginal financial position.

In 2012-13, payments were made to 16,023 individuals who were eligible under the scheme. Total payments were around \$260 million. In this same financial year, around \$37 million was recovered from liquidated companies' assets.

Total payments under the General Employee Entitlements and Redundancy Scheme and Fair Entitlements Guarantee Scheme have increased significantly since 2007-08, even though growth in the number of insolvencies has been relatively stable (Chart 8.8).

Chart 8.8: Costs under Fair Entitlements Guarantee compared to insolvencies



Source: Department of Finance.

Provision is made in the forward estimates for expected payments under the Fair Entitlements Guarantee Scheme but as it is a demand driven programme, actual payments will reflect the total number of eligible recipients in that year.

Under the Fair Entitlements Guarantee Scheme, someone who has worked with the firm for 25 years could theoretically receive the equivalent of full pay for 100 weeks, plus other entitlements. By contrast, the amount of redundancy pay under the National Employment Standards is capped at 16 weeks.

Prior to the year 2000, no such government scheme existed. The Fair Entitlements Guarantee Scheme is now an uncapped guarantee. Consistent with the principle that government should not and cannot eliminate or insure every risk to the community, the Commission considers that there is a strong case for re-introducing caps into the payments available under the scheme.

A cap of 16 weeks for redundancy pay could be introduced, with a 26 week cap for total payments under the scheme.

A further option would be to change the wage base upon which the Fair Entitlements Guarantee Scheme applies. Currently the entitlements are paid up to a maximum wage of \$2,451 per week. This could be changed to Average Weekly Earnings, which are currently \$1,105 per week.

The Commission also acknowledges the importance of the Australian Securities and Investments Commission enforcing the penalties companies and directors face when they trade while insolvent.

Recommendation 47: Fair Entitlements Guarantee Scheme

Where a firm enters into liquidation and is unable to pay employee entitlements, the Fair Entitlements Guarantee Scheme makes certain payments to eligible workers. It is important that employers meet their obligations to fund worker entitlements. The Commission recommends changes be made to the Fair Entitlements Guarantee Scheme to:

- a. introduce a cap of a maximum redundancy payment equivalent to 16 weeks' pay; and
- b. limit the wage base for the scheme to Average Weekly Earnings.

Commonwealth medical indemnity

Since 2003, the Commonwealth has subsidised the indemnity insurance premiums of medical practitioners in Australia and provided financial assistance to indemnity providers and eligible medical practitioners in high-cost claims. This followed the collapse of HIH Insurance in 2001 and United Medical Insurance in 2002.

The State governments manage public sector medical indemnity insurance, while medical indemnity insurers provide professional indemnity insurance to individual clinicians.

The Department of Health administers a number of schemes designed to maintain and improve premium affordability for medical practitioners. In 2011, the Commonwealth consolidated a number of the schemes that support medical indemnity and professional indemnity for midwives by establishing the Medical Indemnity Insurance Fund.

In 2013-14 the cost to the Commonwealth for the Fund is expected to be around \$100 million.

This Fund incorporates schemes to protect medical practitioners against personal liability for eligible claims that exceed the level of their insurance cover; respond to concerns about the capacity of doctors to pay for run-off cover when they are no longer working; addresses

upward pressure on medical premiums by reducing the cost of large claims to insurers; supports eligible medical practitioners who apply for a subsidised reduction in insurance premiums when their income is below a set threshold; and covers the costs of claims from medical defence organisations that do not have adequate reserves to cover liabilities.

The Commission acknowledges the Commonwealth's role in supporting medical indemnity insurance arrangements, following events in the early 2000s. The Commission considers, however, that elements of the Fund could be scaled back over time.

There is strong evidence that suggests that the market is normalising, including a detailed report by the Australian Competition and Consumer Commission from as far back as 2007-08. Average premiums have reduced since 2003-04, making them more affordable and demonstrating that the industry can sustain premium price reductions. Furthermore, net assets in the medical indemnity industry have increased and major medical indemnity industry insurance companies are continuing to report increased profits.

Within the main Fund, the Premium Support Scheme and High Cost Claims scheme are areas for potential reform. Under the Premium Support Scheme, eligible medical practitioners receive a subsidised reduction in insurance premiums calculated as a percentage of a doctor's private medical income. Insurers are then reimbursed the subsidised amount.

The Premium Support Scheme supports a small and decreasing number of doctors (1,993 in 2012-13). Over this period, the Commonwealth expenditure for the PSS was \$9.3 million, with costs of \$2.4 million to administer the process.

The High Cost Claims scheme was established to address upward pressure on medical indemnity premiums by reducing the cost of these large claims to insurers by reimbursing insurers 50 per cent of the cost of medical indemnity claims above a threshold amount up to the limit of the practitioner's insurance cover.

The impact of ceasing these schemes, particularly in rural areas, should be monitored.

Recommendation 48: Medical indemnity

Following the collapse of HIH Insurance and United Medical Insurance in the early 2000s, the Commonwealth has subsidised indemnity insurance premiums and provided assistance with high-cost claims. There is now evidence that the market is normalising. The Commission recommends the Commonwealth scale back its subsidies for medical indemnity insurance by:

- a. ceasing the Premium Support Scheme;
- b. ceasing the High Cost Claims scheme;
- c. considering grandfathering provisions to support the medical indemnity insurance industry in the transition to reduced Commonwealth subsidisation; and
- d. monitoring the impact on the medical profession, particularly in rural areas.

8.8 Grants programmes

The Commonwealth spent about \$22 billion on grants in 2012-13, across more than 500 programmes. This total — which excludes grants for foreign aid, grants to the States and local governments, and other scholarship grants — represented approximately 6 per cent of total Commonwealth expenditure. It is also double the amount of grants expenditure in 2002-03.

Grants are used to achieve the government's policy objectives in different ways. Grant activities involve individuals, small businesses or the not for profit sector, while others involve large corporations, primary producers or whole industry sectors. Some grants support ongoing delivery of services, infrastructure or research over a number of years, while others provide short-term or one-off assistance.

While the *Commonwealth Grant Guidelines* exist to provide a guide on the overarching requirements for grants administration, agencies largely determine their own practices including advertising, application, agreement and reporting processes.

Disparate grant administration practices within and across agencies can generate red tape and costs for recipients and government. While a single approach is unlikely to suit all grants, there is capacity to improve consistency according to types or categories of grants.

There is also no comprehensive whole-of-government repository of information about grant activity across the Commonwealth at present. This reduces transparency and the quality of information available to government in its decision-making.

Grant assessment and payments processes can be improved by enhancing transparency, raising the capability of staff involved in grant administration and improving the quality and consistency of grants guidelines and application processes.

The Commission considers that significant changes are required to both grants administration and the composition of grants programmes. Better alignment of grants programmes and government priorities is needed. All grant programmes should have measurable outcomes and outcomes achieved should be regularly assessed.

New models of grant development and management should also be considered. For example, 'payment for results' models involve the government paying only for effective interventions. Participatory grant models provide a mechanism for engaging communities and stakeholders in deciding the structure of the grant and the allocation of funding.

Red tape also can be reduced for grant recipients by applying contemporary risk-based approaches to grant management, balancing the need for responsible financial reporting and accountability against reporting burdens placed on grant recipients.

There is also potential to reduce administrative burden and compliance costs, through the use of broad-banding grants programmes (for example in research, Indigenous, family and community support programmes or the arts).

Given the large number of grants programmes, the Commission has identified a sample of grants for abolishing or merging. In addition to the grants identified for abolition elsewhere in this Report, the following eight specific grant programmes are identified for abolition or merging:

- in the Environment Portfolio: the Voluntary Environment, Sustainability and Heritage Organisations programme; the National Environmental Research programme; the Suburban Jobs Program; and the Australian Biological Resources Study National Taxonomy Research Grant;
- in the Communications Portfolio the Community Broadcasting programme; and
- in the Education Portfolio the National School Chaplaincy and Student Welfare programme; the Parliament and Civics Education Rebate; and the Creative Young Stars programme.

The complete list of grants proposed for abolition or merging is at Annex D.

The Commission further proposes that, for each portfolio, all grants programmes with a value of less than \$5 million across the forward estimates should be consolidated. Funding for these grant programmes should also be reduced by 15 per cent by 2015-16.

The Commission understands that the United Kingdom, as part of a broader package of reform, reduced grant budgets by up to 28 per cent over four years as programmes were consolidated and financial control devolved to lower levels of government.

To reduce the proliferation of new Commonwealth grant programmes the Commission recommends that a more rigorous assessment process be adopted at the approval stage, which requires the proposing minister to demonstrate:

- the need for the new grant;
- that a grant is the most appropriate mechanism;
- its relationship with existing programmes;
- why it cannot be accommodated within existing programmes; and
- whether a new model of grant development or management is appropriate or could be trialled.

This would focus consideration on whether a grant is the most appropriate vehicle and, if so, whether an existing programme could be used or augmented to achieve the desired objective.

Recommendation 49: Grants programmes

The Commonwealth spent about \$22 billion on around 500 grants programmes in 2012-13. The Commission recommends significant changes be made to the administration of the Commonwealth's grant programmes including by:

- a. establishing a central register within the Department of Finance of all grants programmes with complete transparency on all grants awarded;
- b. reducing red tape for grant recipients by applying contemporary risk-based approaches to grant management;
- c. decreasing the number of existing grant programmes by abolishing, merging or consolidating existing grants programmes;
- d. addressing the proliferation of new grant programmes by introducing a rigorous grant assessment process at the approval stage; and
- e. ensuring all grants have measurable outcomes which are regularly assessed.

9 – Rationalising and streamlining government bodies

There are too many government bodies in Australia. This leads to duplication and overlap, unnecessary complexity, a lack of accountability, the potential for uncoordinated advice and avoidable costs.

Currently 194 principal Commonwealth bodies operate under the *Financial Management and Accountability Act 1997* and the *Commonwealth Authorities and Companies Act 1997*. (This Report refers to these as Principal Bodies.)

The governance obligations that apply to bodies operating under the Acts can be considerable. The Commission is advised that governance and other related costs vary between bodies but are estimated at being up to \$1 million per year per body.

Additionally, over 120 bodies and committees recognised in legislation exist within departments and agencies, together with some 600 more boards, councils and committees established on an administrative basis.

Despite the plethora of bodies, there is no central repository of information on them. This reduces the government's ability to ensure their work aligns with government objectives and community needs. This must be addressed.

In examining the potential for rationalisation of bodies and agencies, the Commission was guided by the Principles of Good Government outlined in Chapter One, together with additional propositions including:

- the Commonwealth should consider withdrawing from activities that are outside its areas of core responsibilities;
- portfolio departments should undertake policy work, while agencies should deliver programmes and services;
- as far as practicable, bodies should be incorporated into the portfolio department;
- organisations and bodies should capture economies of scale where possible;
- bodies should have clear accountability and focus, with defined roles and performance management measures; and
- the need for independence alone does not justify the establishment of a new operational body.

9.1 Principal bodies

In considering the potential for rationalisation of bodies, the Commission has focused on the 194 principal bodies. They have each been assessed against the criteria outlined above.

The main findings of the Commission are summarised in Table 9.1 below.

Table 9.1: Rationalisation of Commonwealth bodies, authorities and agencies

Action to be taken	No. of bodies
Abolish	7
Merge with other bodies	35
Consolidate into the portfolio department	22
To be privatised	9
Review, with a view to merging, abolishing or transferring	26
Total number of bodies identified for attention	99

Source: National Commission of Audit.

The 99 bodies identified as warranting action represent 51 per cent of the existing principal bodies. (Details are outlined in Annex C to this report.) The Commission recognises that further investigation or consultation may be required regarding these suggested rationalisations.

Bodies recommended for abolition

The Commission has identified one agency prescribed under the *Financial Management and Accountability Act 1997* and six *Commonwealth Authorities and Companies Act 1997* bodies that should be abolished.

- Australian Institute for Teaching and School Leadership Limited. Commonwealth involvement is not warranted as schools are primarily a State responsibility.
- The Australian Reinsurance Pool Corporation. With continued recovery in terrorism insurance markets, there is scope for a gradual Commonwealth exit over the coming years.
- The Clean Energy Finance Corporation. Legislation is currently in the Parliament to abolish this corporation, as part of the carbon tax repeal bills.
- The Climate Change Authority. Legislation is also in the Parliament to abolish this Authority, as part of the carbon tax repeal bills.
- The Export Finance and Insurance Corporation. The rationale for abolishing this body is outlined in Section 8.1.

- Innovation Investment Funds Investments Pty Ltd. This body provides direct subsidies to Australia's venture capital industry. In the same way other industry-specific assistance is recommended for abolition, to avoid distorting resource decisions across the economy, so should this assistance to the venture capital sector.
- Low Carbon Australia Limited. This body is integrated into the Clean Energy Finance Corporation, which is to be abolished.

Large mergers

The Commission has identified a number of opportunities for major consolidations of Commonwealth agencies and authorities.

This includes the potential consolidation of border services agencies; consolidating crime intelligence capability in the Australian Crime Commission; a consolidated Civilian Tribunal; a new Health Productivity and Performance Commission; a single Commonwealth Ombudsman; and a single Arts Council.

These opportunities for consolidation are outlined below.

Recommendation 50: Reduce the number of government bodies

There are too many government bodies. This can lead to duplication, unnecessary complexity and a lack of accountability. The Commission recommends that a significant rationalisation be undertaken of 99 Commonwealth bodies operating under the *Financial Management and Accountability Act 1997* and the *Commonwealth Authorities and Companies Act 1997* including by:

- a. reducing the number of existing bodies by 73, including those in Recommendations 51 to 54, by:
 - i. abolishing seven bodies;
 - ii. merging 35 bodies;
 - iii. consolidating 22 bodies into departments and agencies; and
 - iv. potentially privatising nine bodies; and
- b. reassessing the operations and continuing need for 26 other bodies.

Consolidation of border protection services

Border protection and security is integral to national security. The seamless flow of people and cargo across Australia's borders is also critical to the country's success as an open, trading nation.

Protecting and securing our borders requires a range of functions across the border continuum as well as international cooperation, intelligence gathering, maritime patrols and inspections and identity checks. Three principal agencies now perform these functions: the Department of Immigration and Border Protection; the Australian Customs and Border Protection Service; and the biosecurity operations of the Department of Agriculture.

These agencies employ around 17,000 staff and cost around \$7.8 billion to run. The border agencies also collect in excess of \$11 billion of revenue through visa application charges, the passenger movement charge and import processing charges.

Australia's border control arrangements should be highly effective and efficient. Yet authority and accountability for border control is fragmented across agencies, portfolios and ministers.

Given recent trends and developments (including in technology) a more effective approach to border management will require a series of integrated activities both beyond and within the border. A continued effort to improve intelligence-led, risk-based approaches will ensure better border management to deal with material threats while the vast majority of people and cargo, which are low risk, are easily moved.

Continued growth in electronic lodgement and on-line processing, which reduce transaction cost and improve information capture, is essential. More efficient collaboration, integration and communication between stakeholders along with early interventions upstream will enhance Australia's capacity to manage its borders.

Our existing multiple border agency and portfolio arrangements do not provide the optimal structure to pursue these objectives.

The Commission suggests a single, integrated border agency, to be known as Border Control Australia be considered. This would combine the border control functions of Customs and the Department of Immigration and Border Protection in a single agency.

Responsibility for all policy and regulatory functions relating to immigration and customs would be retained within the Department of Immigration and Border Protection. Border Control Australia would be responsible for cargo and services at the border as well as other related functions, including processing visa applications and running the immigration detention network.

The biosecurity functions of the Department of Agriculture would be retained separately for now. This recognises the role of biosecurity is broader than enforcing quarantine law at the

border, with the Commonwealth having some 2,500 'post-entry' quarantine facilities and accredited premises. It also works closely with industry, business and technical experts to ensure exports meet the quarantine standards required by export destination countries.

A consolidation of Australia's border services has the potential to generate significant savings by removing duplication, better integrating and improving operational systems and practices, reducing staff, as well as consolidating back office functions and rationalising property. Savings could also come from greater efficiency in visa processing.

Recommendation 51: Consolidation of border protection services

Border protection and security is integral to national security. The Commission recommends that a single, integrated border agency, to be known as Border Control Australia, be established through the merger of the border control functions of the Department of Immigration and Border Protection and the Australian Customs and Border Protection Service.

Consolidated crime intelligence capability

Criminal law enforcement is increasingly dependent on strong intelligence collection and analysis, including sophisticated financial intelligence and an ability to track the flow of money. Intelligence enables law enforcement agencies to target areas of greatest risk and cooperate with the private sector to identify and address vulnerabilities.

Over time, the Commonwealth has created a number of separate national criminal law enforcement and intelligence agencies to serve different needs. The Australian Federal Police is the Commonwealth's primary criminal law enforcement body. A number of other agencies have limited criminal law enforcement powers in specific areas, such as the Australian Customs and Border Protection Service.

Various agencies are also responsible for crime intelligence and information matters, including the Australian Crime Commission, CrimTrac, the Australian Transaction Reports and Analysis Centre (AUSTRAC) and the Australian Institute of Criminology.

While these agencies are working effectively together, the Commission considers Crimtrac should be merged in to the Australian Crime Commission to better harness their collective resources. A consolidated crime intelligence capability would also better support law enforcement operations by the Australian Federal Police and other Commonwealth and State agencies.

The Commission also considers that AUSTRAC should be reviewed to determine if it should also form part of the Australian Crime Commission, while relocating the Australian Institute of Criminology to a university should be considered.

The Australian Federal Police and the Australian Crime Commission should remain separate agencies to ensure that the latter maintains its national criminal intelligence role, with a focus on strategic risks, and the continued involvement of State law enforcement partners in its governance.

In addition, the Australian Crime Commission has the ability to use special intelligence gathering and coercive powers which should continue being separate from the Australian Federal Police.

The implementation of this recommendation will require consultation with the States. It is critical their interests are reflected, including through the continued representation of the State police commissioners on the Australian Crime Commission board.

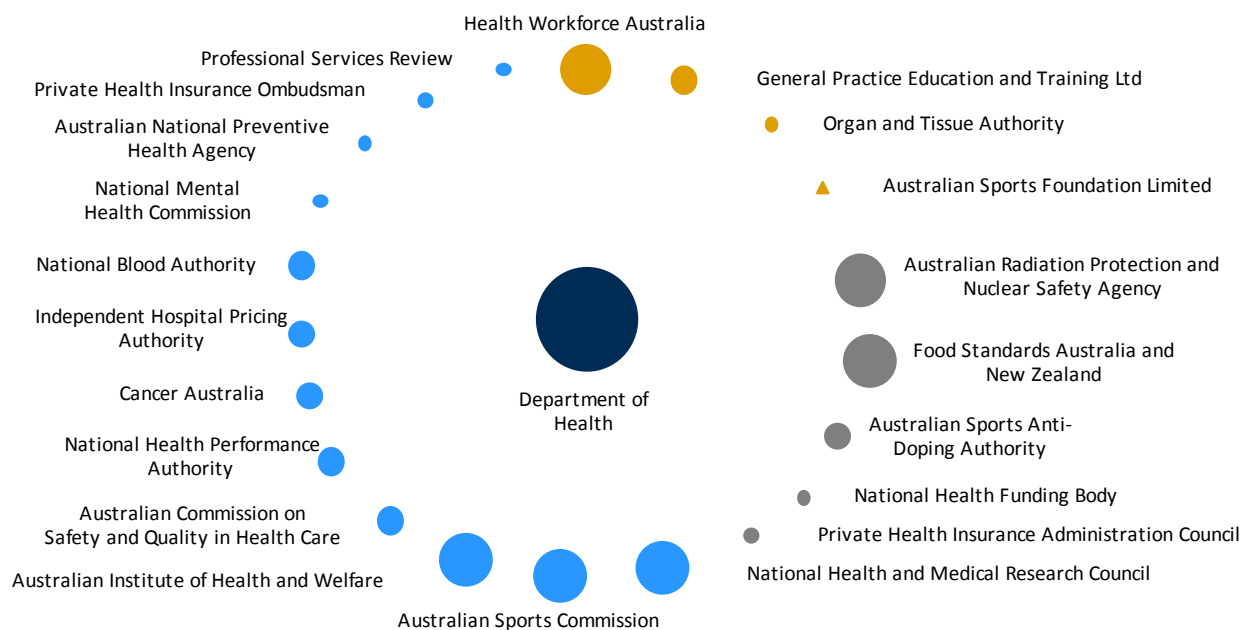
Recommendation 52: Consolidated crime intelligence capability

Criminal law enforcement is increasingly dependent on strong intelligence collection and analysis. The Commission recommends that CrimTrac be merged with the Australian Crime Commission to better harness their collective resources.

Consolidation of health bodies

There are 22 bodies within the Health Portfolio, along with numerous associated boards, councils and committees.

Chart 9.1: Health Portfolio Structure



Source: National Commission of Audit.

In addition to the broader reforms to Australia's health system proposed in Sections 7.3 and 7.4, the Commission proposes three broad actions to address the number of bodies in Health.

- Establish a single National Health and Medical Research Institute.
- Establish a new Health Productivity and Performance Commission.
- Consolidate a number of remaining bodies into the Department of Health.

The Commission recognises that many elements of Australia's health system are underpinned by cooperation between the Commonwealth and the States. As such some of the approaches recommended below may require consultation with the States.

National Health and Medical Research Institute

The creation of a new national health institutes flagship would combine the National Health and Medical Research Council, Cancer Australia and the research budget of the Australian National Preventative Health Agency.

The new institute would align and fully embed health and medical research in the health system. This would improve patient outcomes and deliver efficiencies by improving the evidence base available to clinicians and patients.

Health Productivity and Performance Commission

Multiple agencies now collect data and report on health outcomes. The Commission considers it is possible to improve data collection, analysis and information to inform decisions on health-related measures.

A new independent Health Productivity and Performance Commission could coordinate, report and drive performance across the health care system. This would include identifying innovative options to increase efficiency across the sector and publicly reporting health performance statistics and outcomes. Corporate functions would be supplied by the Department of Health.

The commission would be formed through a merger of the Australian Commission on Safety and Quality in Health Care, the Australian Institute of Health and Welfare, the Australian National Health Performance Authority, components of the Australian National Preventative Health Agency, the Private Health Insurance Administration Council, the Independent Hospital Pricing Authority, the National Health Funding Body and the National Mental Health Commission.

Consolidation of agencies into the Department of Health

The Commission also recommends five bodies be considered for consolidation into the Department of Health.

- Australian Organ and Tissue Donation and Transplantation Authority and National Blood Authority, which could be brought together within the department to harness expertise.
- General Practice Education and Training Ltd and Health Workforce Australia, which could be brought together as a clinical training unit.
- The Professional Services Review scheme.

In addition, in Section 7.4 the Commission proposes that a new authority (the 'PBS Entity') be established in the Health Portfolio to manage the funding of new and currently listed medicines; negotiate prices for existing drugs; and make decisions about de-listing drugs.

Recommendation 53: Consolidation of Health bodies

There are 22 bodies and agencies within the Health Portfolio, along with numerous associated boards, councils and committees. The Commission recommends that a significant consolidation of Commonwealth health related bodies be undertaken by:

- a. establishing a National Health and Medical Research Institute to better align and embed health and medical research in the health system;
- b. establishing a Health Productivity and Performance Commission by consolidating seven existing bodies to better coordinate, report and drive performance across Australia's health care system with a focus on measurable outcomes; and
- c. consolidating five other agencies into the Department of Health.

Single civilian merits review tribunal

The Commonwealth maintains four main bodies to review the merits of Commonwealth decisions: the Administrative Appeals Tribunal; the Social Security Appeals Tribunal; the Migration Review Tribunal and the Refugee Review Tribunal; and the Classification Review Board.

While these bodies have different responsibilities, funding models and structures, there is merit in moving to a unified tribunal framework.

Merging the resources of the Commonwealth's civilian merits review tribunals can provide significant medium to long-term savings and better services. This is demonstrated by the successful establishment of amalgamated 'super tribunals' in State jurisdictions.

A single tribunal model would also provide the opportunity to reassess whether the cost of multiple layers of external merits review as a right is justified in a modern merits review framework, particularly given judicial review of all decisions is available in the courts.

The Commission proposes that Commonwealth civilian merits review tribunals should be amalgamated within the Administrative Appeals Tribunal.

The Commission does not propose the Veterans' Review Board be included as it essentially operates as a division of the Department of Veterans' Affairs and focuses on defence-related matters.

Given potential financial and cultural hurdles could impede the proposed consolidation of tribunals, amalgamation might be best undertaken incrementally.

Recommendation 54: Single civilian merits review tribunal

The Commonwealth currently maintains four main bodies to review the merits of Commonwealth decisions. The Commission recommends that the Commonwealth civilian merits review tribunals (the Social Security Appeals Tribunal, the Migration Review Tribunal and the Refugee Review Tribunal) and the Classification Review Board be amalgamated with the Administrative Appeals Tribunal.

Other consolidations

The Commission also recommends the following actions to reduce the number of government bodies.

The Commonwealth has various ombudsman offices, including the: Commonwealth Ombudsman; Norfolk Island Ombudsman; Overseas Students Ombudsman; Immigration Ombudsman; Law Enforcement Ombudsman; Defence Force Ombudsman; Taxation Ombudsman; Postal Industry Ombudsman; Fair Work Ombudsman; and Private Health Insurance Ombudsman.

In addition, the Inspector-General of Taxation reports to government on the performance of Australian Taxation Office processes, identifying how to reduce the administrative burden for taxpayers.

A number of functions have already been consolidated into the Commonwealth Ombudsman's office recognising the similarity of the underlying functions.

In light of this and in accordance with its principles, the Commission considers the existing ombudsman offices and the Inspector General of Taxation should be amalgamated within the Office of the Commonwealth Ombudsman.

Bringing together the Australia Council, Australian Business Arts Foundation Ltd, Screen Australia and Bundanon Trust into a single arts council will reduce administrative costs and support closer collaboration within the arts community. It will provide improved capacity for grant and procurement processes to be centrally and professionally managed. The Commission notes that the Bundanon Trust will likely need to be maintained within the new Arts Council to some degree, given the terms of a gift from the Boyd family.

The Australian Film, Television and Radio School could be transferred to a university or vocational education institution with an option for the Arts Council to fund scholarships. This is consistent with the principle that the Commonwealth should withdraw from activities that are outside its areas of core responsibility and could be more efficiently and effectively undertaken by the private sector or another jurisdiction.

Other proposed changes by portfolio

Agriculture

The Commission notes and supports the recent passage of legislation to merge the Grape and Wine Research and Development Corporation and Wine Australia Corporation from 1 July 2014.

The National Industrial Chemicals Notification and Assessment Scheme (currently in the Department of Health) could be merged with the Australian Pesticides and Veterinary Medicines Authority to create a new Chemicals Australia body in the Industry Portfolio.

Attorney-General

It would be possible to merge the Federal Court of Australia with the Family Court and Federal Circuit Court of Australia. This would reduce administrative costs and provide additional opportunities to share facilities and streamline back-office functions to achieve more efficient administration of justice.

The Australian Law Reform Commission should also have its functions moved into the Attorney-General's Department (recognising the need to maintain its statutory mandate).

Communications

Opportunities exist to consider the privatisation of Australia Post and for the longer-term privatisation of NBN Co. These issues are discussed in Section 10.1.

The Telecommunications Universal Services Management Agency should be moved into the Department of Communications. This would help streamline administration of the Universal Service Obligation.

Defence

As discussed above, the Commission considers that the Defence Materiel Organisation should be consolidated into the Department of Defence. Defence Housing Australia should be considered for privatisation (see Section 10.1).

In addition, the Commission considers that the various canteen and trust funds should be assessed to determine if their activities need to remain within the public sector. This includes the AAF Company, Army & Air Force Canteen Service, Australian Military Forces Relief Trust Fund, RAAF Veterans' Trust Fund, RAAF Welfare Recreational Company, Royal Australian Air Force Welfare Trust Fund, Royal Australian Navy Relief Trust Fund and Royal Australian Navy Central Canteens Fund.

Education

The Australian Curriculum, Assessment and Reporting Authority should be consolidated into the Department of Education.

The Tertiary Education Quality Standards Agency should be merged with the Australian Skills Quality Authority (from the Industry Portfolio). This should reduce reporting and other requirements for institutions that currently deal with both bodies.

Employment

Several bodies in the Employment Portfolio could be consolidated into the Department of Employment: the Asbestos Safety and Eradication Agency; Comcare, including the Safety, Rehabilitation and Compensation Commission and the Seafarers' Safety, Rehabilitation and Compensation Authority; Safe Work Australia; and the Workplace Gender Equality Agency.

Environment

In the Environment Portfolio, the Commission recommends consolidating the Director of National Parks function into the Department of the Environment as a division, while retaining the role of director as a statutory position.

The Murray-Darling Basin Authority should also be consolidated into the department, noting that this can reduce costs and achieve independence. Separate account and funding arrangements could be established to ensure financial independence.

The National Water Commission could be consolidated into the department, given its small size, which will provide administration cost savings. Alternatively, its monitoring, audit and assessment functions could be transferred to the Productivity Commission.

The Sydney Harbour Federation Trust should be transferred to the New South Wales Government or consolidated into the department as part of the Director of National Parks function and be reviewed to ensure its land holdings are being appropriately managed and utilised.

The Commission also recommends abolishing the Climate Change Authority and Low Carbon Australia Limited, noting legislation to abolish the Climate Change Authority is currently before Parliament as part of the carbon tax repeal bills.

Finance

Consideration should be given to consolidating Comsuper into the Commonwealth Superannuation Corporation, which is its only client.

The Albury-Wodonga Development Corporation should be wound up given it has successfully sold much of its landholdings. Any residual landholdings could be transferred into the department to achieve economies of scale and reduce administration costs.

ASC Pty Ltd should be considered for its privatisation potential (see Section 10.1).

Foreign Affairs and Trade

As outlined in Chapter Eight, the Australian Trade Commission (Austrade) should be consolidated into the Department of Foreign Affairs and Trade, noting the growing maturity of global markets and Australia's export sector, as well as the fact it assists only a small portion of Australia's exporters.

Tourism Australia should be consolidated into the department.

The Export Finance and Insurance Corporation should be abolished.

Human Services

Australian Hearing should be reviewed with a view to privatisation (see Section 10.1).

Industry

In addition to the potential rationalisation of a number of industry assistance programmes, scope exists to rationalise agencies and bodies within the portfolio, including consolidating the Australian Renewable Energy Agency into the Department of Industry.

The merging of the Australian Skills Quality Authority is discussed above.

Infrastructure and Regional Development

Commonwealth involvement with the National Capital Authority should be re-assessed with a view to transferring functions to the Australian Capital Territory Government. The

Commission also recommends a review of the National Transport Commission to determine whether the body should continue or cease operations.

Scoping studies of the Australian Rail Track Corporation and Moorebank Intermodal Company should be undertaken with a view to privatisation – see Section 10.1.

Prime Minister and Cabinet

The recent consolidation of Indigenous programmes into a single department provides an opportunity to improve cohesion and programme delivery. However, consistent with the above proposition that portfolio departments should undertake policy work and agencies should deliver programmes and services, the Commission sees merit in moving the programme and service delivery functions into a new body, the Indigenous Affairs Agency.

The Commission notes that there are a significant number of Indigenous bodies, including approximately 20 in the Prime Minister and Cabinet Portfolio. The Commission suggests that the department should undertake a review of all Indigenous bodies, with a view to significantly reducing the number of bodies to improve delivery and accountability. The Commission acknowledges that these matters are likely to require consultation with stakeholders. Further recommendations about Indigenous bodies are set out in Section 8.3.

The Commission considers merging the Indigenous Land Corporation and Indigenous Business Australia could achieve efficiencies, avoid duplication (these organisations already share a common chair) and be more convenient for clients. The Aboriginal and Torres Strait Islander Land Account should be maintained to provide a stable revenue stream to fund Indigenous land acquisition and management activities.

The Office of the Commonwealth Ombudsman should be expanded to bring together all Commonwealth ombudsman offices including the Private Health Insurance Ombudsman and Fair Work Ombudsman.

Treasury

The Commission recommends abolishing the Australian Reinsurance Pool Corporation (over time) and the Clean Energy Finance Corporation.

The Commission recommends merging the Auditing and Assurance Standards Board and the Australian Accounting Standards Board, consolidating the Corporations and Market Advisory Committee into the Department of the Treasury and moving the National Competition Council's functions into the Productivity Commission (recognising there may be sensitivities with it retaining some regulatory responsibilities).

The functions of the Australian Securities and Investments Commission, particularly areas of overlap with the Australian Prudential Regulation Authority and the Australian Competition

and Consumer Commission, should be considered in the context of the Financial System Inquiry.

In the meantime, the registry functions of the Australian Securities and Investments Commission should be transferred to the Australian Taxation Office, its consumer protection functions transferred to the Australian Competition and Consumer Commission and its financial literacy functions should cease.

9.2 A central register and new guidelines for establishing bodies

The Commission recommends establishing a central register of Commonwealth bodies. The existing lack of centrally held information is a major weakness that does not facilitate effective government.

The Commission recognises that there will always be demands on governments to establish new bodies. However, when a new body is being considered, a major misconception is that its creation will lead to greater independence. Often the need for independence may be satisfied without the need to establish an entirely separate body.

Given the significant operating and governance costs of government bodies, the Commission's view is establishing any new body should require Cabinet agreement.

In seeking this agreement a proposing minister should submit:

- the case for a new body;
- compelling advice on why the function cannot be undertaken within the department or another existing body;
- advice on how the cost of corporate functions will be minimised, including whether they will be provided by the department or a shared service provider;
- advice on how the new body will interface with, but not duplicate, the activities of existing bodies; and
- a proposed termination date.

Recommendation 55: A central register and new guidelines for establishing bodies

There is currently no central register of Commonwealth bodies. Given the significant operating and governance costs of new bodies, the Commission recommends that:

- a. a central register of Commonwealth Government bodies be established and maintained by the Department of Finance; and
- b. new guidelines be established on the creation of new bodies recognising the primacy of ministerial responsibility and the role of departments, including requiring Cabinet agreement.

9.3 Boards, committees and councils

As well as the 194 principal bodies, the Commonwealth supports around 700 other boards, committees and councils.

There is considerable scope to rationalise these bodies. The Commission has commenced a preliminary examination of some of these bodies and may recommend actions in its Phase Two Report.

As well, the Commission proposes each department reassess all bodies within its portfolio (including boards, committees and councils) with a view to reducing their number and associated overheads.

The following criteria will assist departments in this process and inform decisions on retaining or ceasing the operation of existing committees.

1. Bodies (including boards, committees and councils) involved in a single process should be consolidated.
2. Subcommittees should be integrated into the lead committee, where possible.
3. Governance committees for boards, committees and councils should be part of the relevant department's governance frameworks.
4. Bodies should be abolished if:
 - a. functions are no longer required;
 - b. functions could be more effectively or efficiently undertaken by the private or not-for-profit sector;
 - c. functions are outside the Commonwealth's core areas of responsibility; or
 - d. the body exists solely to appoint members to another body.

Recommendation 56: Reduce the number of boards, committees and councils

As well as the 194 principal bodies, there are around 700 other bodies including boards, committees and councils that the Commonwealth supports. The Commission recommends:

- a. each department reassess all bodies within its portfolio with a view to reducing their number and associated overheads, consistent with the criteria set out in Section 9.3; and
- b. all bodies, including boards, committees and councils be included on the central register of Commonwealth bodies.

10 – Improving government through markets and technology

The Commission has been asked to report on efficiencies and savings to improve the effectiveness of government. This can involve contestability of services, the adoption of new technologies in service delivery and within government, consolidating support functions and privatising Commonwealth assets.

A consistent theme through this report is the need for taxpayers to know that public money is being spent wisely, while ensuring quality services are provided.

Community expectations of government service provision have changed significantly in recent years, given advances in information technology. The community now demands a bigger say in the planning, organisation and delivery of government services (as is evident in the National Disability Insurance Scheme) and expects more of them to be tailored to their needs and provided online.

Some 30 years ago, government itself was seen as the provider of services. Today it is more acceptable for government to fund or purchase services on behalf of citizens and it should look to buy them from the most efficient supplier.

In this regard, bureaucratic, one-size-fits-all approaches are being rejected. Governments face challenges to adapt and secure better value for both services it purchases itself (including information technology and corporate services) and those it provides to the public.

These issues are discussed below.

Market based solutions

10.1 Privatisations

After considerable privatisation activity from 1990 through to 2006 (including the Commonwealth Bank, Qantas, Telstra, the Commonwealth Serum Laboratories and National Rail), the issue of privatisation has been largely dormant at the federal level. There has, however, been an increase in privatisations at the State level including QR National, some electricity generators and retailers and port sales in New South Wales.

There is significant capital locked up in Commonwealth commercial or semi-commercial businesses and bodies that could be put to better use if private ownership is suitable. The Commonwealth currently holds around \$13 billion of equity in government business enterprises.

Twenty years ago, the Hilmer Report highlighted significant gains to the community from opening up government enterprises and other areas of the economy to competition. The Commission considers that Commonwealth bodies that operate and compete in contestable markets should be considered for their privatisation potential.

The starting point of any programme would be those bodies, such as government business enterprises, that operate commercially and are ready for sale. Other bodies with potential for sale may first need to be put on a more commercial footing.

Planning should also consider whether a privatised entity should have ongoing community service obligations where businesses operate with cross subsidies, such as Australia Post and the Australian Rail Track Corporation.

Other Commonwealth assets, including land and buildings, also have potential for sale. This issue is addressed in the next section.

In terms of a broader privatisation agenda, the minimum timeframe generally required to progress the sale of a major entity is 12 to 18 months, although for complex sales, particularly where legislation is required, the timeframe is likely to be longer.

Established practice is for the privatisation process to progress in two phases.

- Phase 1: a scoping study to consider the objectives for a sale, including: any community service obligations; regulatory or legislative requirements; actions required to prepare the business for sale; the industry in which the entity operates; and preferred method of sale.
- Phase 2: proceeding with implementing the sale, subject to the findings of the scoping study, prevailing market conditions and obtaining policy approval.

Medibank's potential sale is already announced and a scoping study commenced in October 2013.

The Commission considers a modest privatisation agenda for Commonwealth assets (and interest in assets) should be pursued across the short, medium and longer term. Entities considered suitable for privatisation are identified below.

Short term (2014 to 2016)

Australian Hearing – as a regulator, funder and owner of Australian Hearing, the Commonwealth plays a significant role in the hearing services market. The Government could examine the potential to increase contestability in markets where Australian Hearing has a monopoly and allow, through privatisation, it to compete in markets where it is currently precluded.

In addition, a scoping study could examine the future of the National Acoustics Laboratory and the appropriate model of industry regulation to preserve the intent of existing community service obligations.

Snowy Hydro – Snowy Hydro operates in the highly contestable National Energy Market and is the third largest electricity generator by installed capacity. The public interest case for ongoing government ownership is not strong. The Commonwealth is a minority shareholder in Snowy Hydro, with a 13 per cent share compared with the 58 per cent stake owned by New South Wales and Victoria’s 29 per cent.

The New South Wales Commission of Audit’s 2012 report also recommended considering Snowy Hydro’s divestment.

A scoping study could examine the potential benefits of a sale for the operation of the National Electricity Market and implications for the management of water resources.

Defence Housing Australia – the property ownership and management industry is a competitive and commercial market. It is highly likely the private sector can meet the housing needs of the Australian Defence Force and members’ families.

A scoping study could examine Defence housing policy and the ability of the private sector to meet the requirements of Defence personnel while also meeting the Defence Force’s operational requirements.

ASC Pty Ltd – formerly the Australian Submarine Corporation, ASC is a supplier of naval combat vessels as well as being a specialist submarine provider. It competes against domestic and international shipbuilders and is currently involved in the Air Warfare Destroyer Alliance arrangement.

ASC’s recent financial returns have been poor and the company is heavily dependent on future submarine projects. Existing government policy is to ensure work on a replacement submarine fleet is centred on the South Australian shipyards. While ASC is the only South Australian based shipbuilder with experience in submarines, this does not assure it of a leading role.

Notwithstanding the challenges facing the company, the Commission believes there would be merit in selling ASC as soon as is practicable.

Medium term (Post 2016)

Australia Post – the majority of Australia Post’s business is in the competitive retail, parcels and logistics markets. Due to the increased use of e-mail and other forms of electronic communication, Australia Post is facing a rapid decline in its letter volumes. While this same trend has led to an increase in online shopping and growth in Australia Post’s parcels business, it only partly offsets the costs of the decline in letter volumes.

The scoping study would need to examine community service obligations in letter delivery and other 'reserved' services.

The Moorebank Intermodal Company – the company's role is to develop and operate an intermodal terminal as a flexible and commercially viable common user facility available to rail operators and other terminal users. Moorebank Intermodal Company intends to achieve this by leasing land that the Commonwealth owns and acquires for the intermodal terminal, gaining relevant environment and planning approvals, undertaking a request for tender for the intermodal terminal's development and operation and then managing the funding required for its development.

The Commonwealth's ongoing support of the Moorebank Intermodal Company supports the project to deliver upon its objectives of improving national productivity through an efficient supply chain, increased freight capacity and better rail utilisation. Then, subject to market conditions, the Commonwealth intends to privatise its interest in the project.

Australian Rail Track Corporation (ARTC) – the Commonwealth could privatise either all of ARTC, or just the Hunter Valley network. The monopoly characteristics of ARTC's network can be adequately managed and regulated in the public interest, much the same as airport and electricity distribution monopolies.

A scoping study could examine an appropriate access regime, implications for ARTC's leases and wider considerations stemming from the intergovernmental agreement that established the ARTC.

Royal Australian Mint – the Royal Australian Mint manufactures Australia's coins while Note Printing Australia, a subsidiary of the Reserve Bank of Australia, prints Australia's notes and competes internationally for note printing contracts. As there is an international market for manufacturing currency, there is merit in reconsidering the public interest case for retaining the Royal Australian Mint as a government body and its potential for privatisation.

COMCAR – the Department of Finance provides the Commonwealth's car-with-driver service (COMCAR) to parliamentarians and other high level officials and dignitaries. COMCAR also provides transportation services for guests of government and major events, such as the forthcoming G20 programme. Many of these services are provided in competition with the private sector and there is merit in considering privatisation options.

A scoping study could examine issues including legislative requirements relating to entitlement to the service and maintaining appropriate security arrangements.

Long term

NBN Co – provisions for the eventual privatisation of NBN Co and the National Broadband Network are already in place. The existing legislation governing NBN Co requires the Commonwealth to maintain ownership of the company at least until the network is built

and fully operational, which according to NBN Co's recent strategic review will not be before the end of 2020.

The revenue achieved from a potential future sale of NBN Co is included in the projected internal rate of returns contained in the six scenarios outlined in the review. The Government has not yet responded, but it is likely that the long-term future of NBN Co will include an eventual privatisation.

Recommendation 57: Privatisations

Twenty years ago, the Hilmer report highlighted the gains to the community from opening up government enterprises to competition. The Commission considers that Commonwealth bodies that operate in contestable markets should be privatised. The Commission recommends that the following 10 bodies be privatised over the short, medium and long term, in accordance with established practice.

Short term

- a. Australian Hearing Services.
- b. Snowy Hydro Limited.
- c. Defence Housing Australia.
- d. ASC Pty Ltd.

Medium term

- a. Australian Postal Corporation.
- b. Moorebank Intermodal Company Limited.
- c. Australian Rail Track Corporation Limited.
- d. Royal Australian Mint.
- e. COMCAR.

Long term

- a. NBN Co Limited.

10.2 Management of the Commonwealth property portfolio

The Commonwealth's property portfolio (the Commonwealth Estate) is diverse. It comprises:

- the Defence estate of about 3 million hectares, with some 400 owned properties including 72 significant bases, 25,000 buildings and 6,000 other structure assets. The Defence estate has an estimated value of \$20 billion;
- the Finance estate of 106 properties including key accommodation (such as the Treasury Building and John Gorton Building); special purpose properties (including the Commonwealth Law Courts and the ASIO headquarters); vacant land; and properties with heritage and other unique features. This estate has an estimated value of around \$1.4 billion; and
- overseas property interests managed through the Department of Foreign Affairs and Trade and valued at about \$1.5 billion.

In addition, Defence Housing Australia manages a total portfolio of 18,300 properties valued at around \$10 billion. The CSIRO is also a significant holder of land and buildings. Its assets include some 1,000 buildings on 54 locations, with a land value of about \$378 million and \$1.1 billion for buildings.

The Commonwealth also leases office accommodation and specialist accommodation with over 600 leases in place for office space.

Management of the Commonwealth Estate presents challenges, reflecting the nature of the property, legislative obligations and legacy issues such as contamination and underinvestment in repairs and maintenance.

Since 1996, large-scale disposals and outsourcing of services peripheral to the government's core responsibilities have led to the divestment of many of the commercially attractive Commonwealth properties. However, a significant number of properties remain in the Estate.

There is no complete whole-of-government public register of Defence and non-Defence Commonwealth-owned property, although a *Register of Surplus Commonwealth Land Potentially Suitable for Housing and Community Outcomes* is publicly available on the Finance website. The register contains details of surplus Commonwealth land considered potentially suitable for housing and community outcomes, but is not a full list of surplus Commonwealth land holdings.

The Commission considers a central register of the whole of Commonwealth property estate should be established.

The government's core expertise does not and should not relate to the development, maintenance and leasing of office accommodation and other buildings that are commercially available. This is best left to the private sector.

A proposal to privatise Defence Housing Australia is outlined in Section 10.1.

The Commission considers further divestment of surplus Commonwealth property and land should be pursued with oversight from an independent private sector property expert. The process should entail identifying a list of suitable domestic properties including indicative divestment priorities and timelines; the risks associated with each property; and management strategies that may address the risks, in part or full. Representatives from the Commonwealth's major property owners — the Department of Defence and the Department of Finance — should participate in this process.

The Commission recognises the current policy of returning all divestment proceeds to the Budget provides little incentive for agencies to pursue property divestment. Allowing agencies to retain a portion of sale proceeds has the potential to provide an incentive for them to assist in meeting broader divestment objectives.

The Commission also recognises property ownership, development and management requires considerable experience and skill that the Commonwealth often finds difficult to acquire and retain. Making greater use of contracted professional property managers is one way of achieving this.

Recommendation 58: Management of the Commonwealth Estate

The Commonwealth's property portfolio (the Commonwealth Estate) is diverse and of significant value. The Commission recommends that the management of the Commonwealth's property portfolio be strengthened, including by:

- a. establishing a central register of Commonwealth Estate properties within the Department of Finance;
- b. drawing on greater private sector experience in property management;
- c. undertaking a further divestment process to be overseen by an independent property expert; and
- d. continuing to use commercially available office and other accommodation as far as possible, ensuring there is competitive tension and value for money.

10.3 Outsourcing, competitive tendering and procurement

For 30 years, competitive tendering and contracting (or outsourcing) has been a key method of delivering many public services.

It has two worthwhile intrinsic features. First it requires government to provide a clear definition of the services involved and second it periodically opens delivery to non-government suppliers.

Benefits of outsourcing include increased flexibility in service delivery, greater focus on outputs and outcomes rather than inputs, and the incentive for private sector suppliers to provide innovative solutions and savings.

However, there can be significant costs, including those associated with contract specification, the competitive tendering process and ongoing contract management and monitoring. It is also necessary to strike the right balance on accountability, privacy, probity and consumer protection.

Outsourcing and contestability are well recognised for their potential to increase government efficiency. Key questions for the Commission are how much outsourcing and contestability already occurs, in what areas, and where are the future opportunities.

Community expectations are increasing for more effective service delivery as well as improved coordination and collaboration, both within the Commonwealth Government and between the Commonwealth, States and Territories, businesses and community organisations.

The Commission has been advised that there is currently no formal, structured approach at the Commonwealth level for the consideration of what services should be contestable and, if warranted, outsourced.

Instead, directions are set by the Australian Government Procurement Statement, which states 'the Government will only contract out when it is in the public interest, having regard to such considerations as the quality and accessibility of services and the implications for affected public sector employees'.

The Commission considers governments should continue to harness the benefits of outsourcing.

Decisions to outsource should be made with reference to a broadly accepted set of principles, with appropriate safeguards to both protect the rights of citizens and provide potential contractors with fair opportunities to compete.

Decisions on outsourcing should also take account of the interests of stakeholders, for example those in rural and remote communities who may be concerned about the effect of (or lack of) competition in the local community.

A successful approach to outsourcing will require an improvement in the expertise of the public service in contract management.

It will also be important to retain an open mind on the types of services, including services that are regulated by government, that have the potential to be delivered by private or non-government organisations.

Areas for early consideration may include Air Services Australia, the administration of parliamentarians' entitlements and the outsourcing of payment services.

The Commission considers Commonwealth procurement policies should also be improved.

The Commonwealth Government spends around \$40 billion on procurement per year, ranging from around 40 procurements of more than \$100 million in value to around 58,000 procurements of less than \$80,000 in value. While value for money is the core principle underpinning government procurement policy, significant opportunities exist to improve efficiency and effectiveness and to take a more strategic approach.

There are currently 24 procurement related policies in operation. They range from Coordinated Procurement to Australian Industry Participation Plans and include various environmental policies, such as the National Waste Policy.

While some are directly related to procurement activities, others have no connection with procurement and seek to put into effect other policy objectives (including equal opportunity employment objectives). These policies contribute a significant amount of red tape for both business and government, are often of questionable benefit and can run counter to the principle of value for money.

The Commission considers Procurement Connected Policies should be abolished as procurement practices are already subject to the normal laws of Australia. They also represent unnecessary red tape and can be an inefficient means of meeting broader policy objectives at high cost to business.

A more strategic approach to procurement is also needed to provide value for money. The interpretation of value for money should reflect a more rigorous and sophisticated approach that looks beyond simple cost per day or cost per unit. A better approach would take into account outcomes, benefit and importantly risk relative to price.

Associated with this reform is a need to build the skills and capabilities of the public sector to enhance competencies around good contracting.

Taking a more strategic approach should also provide the opportunity to strike the right balance between risk management and the effectiveness and efficiency of procurements. Current departmental Chief Executive's Instructions can add unnecessary requirements, which merely duplicate the Commonwealth Procurement Rules or lead to overly cautious

processes. For example, some agencies appear risk averse in dealing with potential suppliers during tender processes – in part due to overly restrictive probity and legal advice.

In addition, bespoke requirements often significantly increase contract costs while adding little to achieving the outcomes sought. Accordingly, there should be greater use of standardisation and reduced use of bespoke requirements.

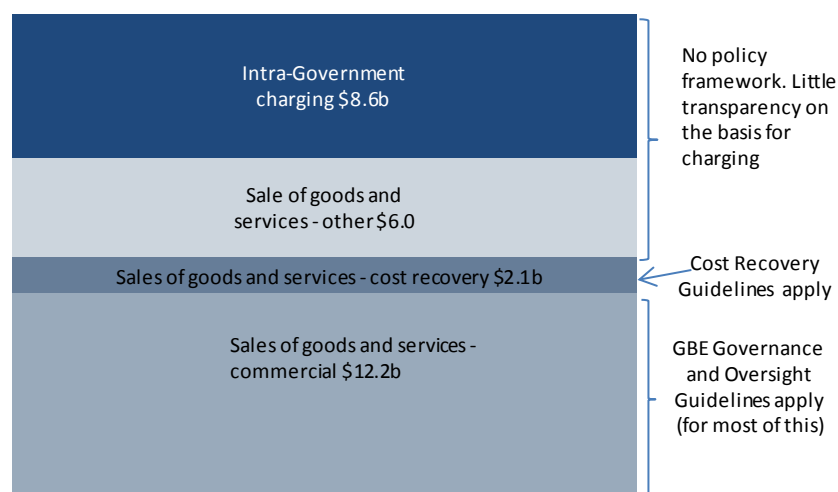
The Commission has also been asked to examine opportunities for greater application of user charging arrangements to the activities of government. This is another area where improved guidelines are required.

As shown in Chart 10.1, Commonwealth entities sell a variety of goods and services to the public and businesses (\$20.3 billion) and to each other (\$8.6 billion). Charging arrangements are thus an important source of revenue. They also result in better resource allocation, as only those that use a government activity pay for it, rather than the broader public. Charges also provide price signals that prevent over-use of government services.

The majority of charging (\$12.2 billion) relates to the commercial operations of government business enterprises, such as Australia Post or Medibank Private. Generally, the government expects these bodies to price efficiently and earn a commercial return.

Of the remaining \$16.7 billion dollars in user charging in 2011-12, the Australian Government Cost Recovery Guidelines covered only \$2.1 billion.

Chart 10.1: User charging 2011-12



Source: Commonwealth Consolidated Financial Statements 2011-12; Department of Finance.

There is an assortment of fees, industry levies, monetary penalties and transfer pricing arrangements within government that lack an overarching policy framework.

An overall user-charging framework would ensure government charges are appropriately set and consistent. This would include consideration of the overall efficiency and economic

impact of charges and better transparency and consultation in planning and implementing charges.

Recommendation 59: Outsourcing, competitive tendering and procurement

Governments should continue to harness the benefits of outsourcing where the benefits outweigh the risks. The Commission recommends that the Government:

- a. re-establish competitive tendering and outsourcing guidelines that reflect contemporary and best practice contract management processes;
- b. base procurement decisions on value for money at all times by abolishing Procurement Connected Policies;
- c. taking a more strategic and professional approach to procurement and contract management;
- d. make greater use of standardised contracts for procurement; and
- e. develop a whole-of-government user charging framework that improves efficiency, accountability and transparency.

10.4 Outsourcing of the Government Payments System

The Department of Human Services delivers over 200 different services for more than 20 Commonwealth and State agencies and is responsible for the payments system they use.

The payments system is governed by laws, rules, procedures and standards that inform assessments of eligibility for welfare, study, aged pension and other payments that comprise entitlements or grants. Once eligibility for the entitlement or grant is established, the Government Payments System transfers funds electronically, by cash or by cheque to the recipient.

The Government Payments System requires a capacity to:

- assess eligibility of entitlements or grants, in respect of relevant laws, rules and standards;
- review eligibility when the circumstances of the recipient change;
- maintain records of recipients and make them available to appropriate agencies as required;
- approve payments from government account to individual clients; and
- report outcomes to the Commonwealth.

The Department of Human Services managed total payments of \$149.4 billion on behalf of government in 2012-13. Each working day it disburses more than \$400 million in payments by way of transfers to individuals' bank accounts through its payment system (the Income Security Integrated System).

The Department of Human Services also shares data from the system with a range of other Commonwealth agencies to prevent fraud.

The Income Security Integrated System was developed to calculate and administer social welfare payments nearly 30 years ago. It is written on now defunct information technology codes, is inflexible and expensive. The system adds significant costs for processing payments, maintaining the ICT system, producing letters and responding to appeals and reviews, and it increases the need for debt recovery.

The current ageing system poses a significant risk to a core function of government.

The Department of Human Services was given authority in the 2013-14 Budget to determine a replacement strategy for its Income Security Integrated System. It is expected that a replacement system will cost around \$1.2 billion to \$1.5 billion. The Commission sees little option but to make this kind of investment for such an important and complex IT infrastructure project.

Three key considerations in the development of a new system are:

- whether the complicated web of government payments can be simplified in parallel with the introduction of a new IT system – this is a question of both policy and administration;
- delivering a design that allows welfare policy changes to be incorporated into the payments system more easily and without the risks that come with the existing Income Security Integrated System; and
- how to achieve the best blend of private and public sector expertise in the development and management of a very complex IT system.

The complexity of the current system arises from a multitude of policy decisions about the structure and goals of the welfare system and ad hoc changes to payments over decades. Many of them are enshrined in legislation. According to the Department of Human Services, the largest driver of complexity in technology and cost is the system's magnitude, which has 34 payments and 38 add-on payment types.

The complexity of the payments architecture and interactions between payments creates customer confusion, errors and rework, and requires a highly knowledgeable workforce to provide support.

The Commission supports the view of the Department of Human Services that welfare payments should be simplified, recognising the challenge this poses for tight targeting of assistance.

Even with a more simplified payment structure, redesigning the IT system is a significant undertaking that will require expertise from across the public and private sectors.

The Commission considers that the Government should appoint a highly credentialed business technology expert to oversee the new system design, working with experts from the Department of Human Services.

Outsourcing of the payments system could also be considered on the basis of prospects for the services to be delivered more efficiently and effectively and at a lesser cost than is the case now. However, the need to redesign such a complex IT system in parallel with the simplification of welfare policy, complicates any decision about outsourcing.

Specialist outsourcing providers prefer high volume, low complexity stand-alone activities because they are generally low risk and can be managed relatively easily. Experience also indicates that outsourcing works best where the required service can be easily specified and monitored and where a competitive market of potential suppliers exists independently of government patronage.

Other factors that influence the success or failure of outsourcing arrangements include: the need for appropriate safeguards to protect the rights of citizens; the quality of the scoping of the requirement being outsourced; and the management of the contract and contract variations.

Outsourcing does not exempt government and ministers from responsibility for failures.

There is market interest in the provision of payment systems. For example, Australia Post has prepared a proposal to deliver a range of government services currently provided by the Department of Human Services.

Under the Australia Post proposal there would be a physical integration of service points for the Department of Human Services within Australia Post's network of retail outlets. The proposal would envisage 334 Centrelink service centres, as well as 126 rehabilitation centres and 139 standalone Medicare offices amalgamated into Australia Post's network.

The Commission recognises outsourcing of the payments system arrangements would be a substantial and potentially high risk undertaking. It requires very careful consideration.

This would include a judgement on whether the assessment of entitlements is an appropriate activity for outsourcing; whether outsourcing should be confined to the development and maintenance of the replacement for the Income Security Integrated System, or whether the payment mechanism only should be outsourced.

The Commission does not support the outsourcing of assessment of entitlements.

However, there may be merit in testing the market for the delivery of other aspects of the payments system. A scoping study should be developed, informed by the advice of a business technology expert.

Recommendation 60: Outsourcing of the Department of Human Services payments system

The Department of Human Services delivers over 200 different services for more than 20 Commonwealth and State agencies and is responsible for the Government Payments System. The system's supporting IT infrastructure is obsolete and arrangements are being made for its replacement. The Commission recommends that the Government:

- a. appoint a highly credentialed business technology expert to oversee the development of the new government payments IT system in collaboration with the Department of Human Services;
- b. establish a policy process to review and simplify the structure of welfare payments in parallel with the design of the new business information technology system; and
- c. develop a scoping study on options for outsourcing part or all of the Department of Human Services payments system.

10.5 Data

To meet increased demand for services in a constrained resource environment, governments must actively manage for innovation through technology. This must include exploiting opportunities that come with the greater availability of data and enhanced data analytic capabilities.

In the business world, companies know their customers. Segmentation — the capacity to understand customer groups and tailor products to suit the needs of each — is a central business strategy to increase sales.

In government, data can similarly be used to tailor service delivery — often to reduce interaction with citizens. Data also offers untapped potential to improve policy development. Data analysis should constantly inform government policies, particularly in areas of complex social policy such as Indigenous affairs and health.

The advent of 'big data', advanced analytics and greater computing power offers an opportunity to better understand citizens' needs and behaviour. The government must keep pace with the private sector and take this opportunity to improve policy outcomes and services.

In going down this path, governments also need to safeguard the community's trust. Australians know that governments already have access to vast amounts of data. As highlighted by research, in return for providing this information citizens expect their information to be secure and to know that it will be used reasonably.

There are three key changes needed to improve the government's use of data to inform policy and tailor service delivery:

- a change in the mindset of government agencies from collecting data for filing to collecting data for use;
- an increase in data sharing, both within and outside government; and
- improved skills in the Australian Public Service to make best use of new data analytics tools.

The Commonwealth Government holds a large amount of data but does not currently use it to best effect. Some agencies collect data in the natural course of their operations and tend to focus more on collection rather than analysis and wider use. Other agencies have developed a number of data initiatives in isolation, which have provided key insights to only a small number of people.

The Commission notes that agencies' efforts on data are rarely connected, sometimes duplicative and often of variable quality with inconsistent standards. The value of data holdings to the whole of government is rarely articulated and the Commission is advised that there has been no effort to undertake a stock take of data holdings or to assess their value.

As a first step in improving the use of government data, each major government agency should prepare a plan for making better use of its own data to inform government policies and services from within existing resources.

Data sharing also needs to be improved to facilitate innovation across agencies and from outside the government.

The Productivity Commission has highlighted that poor access to administrative data for government users, academics and other researchers is undermining evidence-based policy.

Unlike many other countries, Australia makes relatively little use of its public data resources even though the initial costs of making data available would be low relative to the future flow of benefits... A failure to exploit this evidence would be a missed opportunity given Australia's demographic and structural budget challenges.

Data.gov.au provides downloadable public datasets from the Commonwealth, State and Territory governments as well as links to online data services provided by other government

sources. The site is intended to encourage public access by providing data in useful formats and under open licences.

There are currently 3,164 datasets available through Data.gov.au. This compares to around 10,000 datasets in the UK and around 200,000 datasets in the US.

Despite the existence of Data.gov.au, the lack of publicly accessible Australian data in areas such as disability care, aged care, job seekers and disadvantage is hindering insights into whether some of the fastest growing government programmes are meeting their objectives or being delivered effectively. For example:

- administrative data could offer evidence about people's use of income support, linked to health and incarceration data to identify better pathways out of disadvantage;
- greater linking of health data could lead to more efficient and targeted services, yet there are legislative constraints preventing Medicare Benefits Schedule and Pharmaceutical Benefits Scheme data combined for statistical research; and
- a lack of access to administrative data about Job Services Australia currently impedes research into the interactions between welfare and work.

The Commission considers the Government should do more to open access to its administrative data holdings, including medical data (the Pharmaceutical Benefits Scheme, Medicare Benefits Schedule and Medicare) and welfare and social data (social security payment data). At the State level, Western Australia has demonstrated that such administrative data can deliver substantial benefits with low risks, manageable costs and in ways that protect people's privacy, for example, by anonymising data before it is released (i.e. removing identifiable personal details).

The Australian Public Service must also improve its capacity to undertake data analytics.

Data analytics involves analysing very large datasets in real time. This is sometimes referred to as 'big data' and offers the potential to draw insights and identify anomalies in government programmes and services to enable more immediate intervention. For example, in the United Kingdom, analysis of pharmaceutical prescription data showed excessive prescribing of brand-name cholesterol drugs in certain locations over cheaper generic alternatives, at an average cost of £27 million a month to the National Health Service.

The 2013 *Australian Public Service Big Data Strategy* offers a process through to mid-2014 to improve analysis of large government datasets. The Government has committed to review the strategy in 2014 and to seek proposals for joint private-public projects using big data that have promising efficiency or service quality payoffs.

The Commission supports the Government's emphasis on big data. It considers that any new strategy needs to focus on the greater use of data analysis to improve decisions about new policy and programmes and the effectiveness of existing ones.

In line with its commitment, the Government should identify and prioritise several major 'big data' projects, spanning key service delivery bodies (such as the Department of Human Services, Australian Taxation Office and Department of Immigration and Border Protection) and complex policy and programme areas such as services to Indigenous people and health.

The Australian Bureau of Statistics and the Australian Statistician should play a leading role in developing and promulgating a data strategy for the Commonwealth, which includes improving the quality, timeliness and availability of data and boosting the capacity for data analytics within the Australian Public Service.

Recommendation 61: Data

There is untapped potential to use anonymised data and new data analytic techniques to improve the efficiency and effectiveness of government. The Commission recommends that the Government, recognising the need to safeguard privacy concerns, rapidly improve the use of data in policy development, service delivery and fraud reduction by:

- a. requiring major departments and agencies to develop plans to maximise use of their own-source data;
- b. extending and accelerating the publication of anonymised administrative data;
- c. prioritising several 'big data' projects in major service delivery agencies; and
- d. establishing a data strategy to be prepared by the Australian Statistician on the quality, timeliness and availability of data that would be suitable for public release.

10.6 e-Government

With the advent of digital and mobile technology, many government services have become available online and this trend is continuing. Citizens, businesses and other government customers often prefer these e-Government services.

For departments and agencies, e-Government transaction costs are substantially lower. They also provide a level of transparency that militates against the risk of fraud and corruption.

Progress towards developing and executing an e-Government strategy in Australia has been slow, with a range of legislative barriers to greater provision and uptake of digital transactions.

Australia should follow the lead of the United Kingdom and implement a 'digital by default' strategy.

The Department of Human Services myGov service should be the centrepiece of an aggressive new approach.

The myGov service allows people to access government services from Medicare, Centrelink, Child Support, the Department of Health, the Department of Veterans' Affairs and the National Disability Insurance Agency using one user name and password online and via mobile apps.

The Australian Taxation Office is scheduled to join in March 2014 through its e-tax product and new web and mobile services. myGov recently added a digital mailbox service to provide a secure electronic mail delivery channel for official correspondence. This service links with the Australia Post Digital Mailbox facility and also has potential to link with commercial providers.

The Commission has been advised that the myGov service has around 2 million registered members and is accessed by over 150,000 users each week. A further 2 million users are anticipated to register by mid 2014, with the service further expanding to link with State, Territory and local government services.

In addition to myGov, other government services are available online. The Australian Taxation Office, Department of Immigration and Border Protection and the Australian Customs and Border Protection Service in particular have made progress to date.

- The Australian Taxation Office has offered online tax returns for individuals for many years, and has introduced Standard Business Reporting, which allows firms to lodge tax returns with government agencies directly from the software they use for financial reporting. The recent introduction of the SuperTICK service for superannuation funds to check client identity is another example.
- The Department of Immigration and Border Protection has processed visas electronically since the 1990s through the Electronic Travel Authority, which links into airline booking systems.
- The Australian Customs and Border Protection Service uses electronic cargo manifests to risk assess imported goods and is increasingly giving eligible travellers the option to self-process through passport control using SmartGate, the ePassport and face recognition technology that performs customs and immigration checks usually conducted by an officer.

However, there is still a long way to go to realise the potential benefits of online service delivery.

In 2012, 50 per cent of services provided by the Department of Human Services were not conducted online. The Australian Taxation Office reports it is required by legislation to send over 10 million notices of assessment in hard copy. It sends a further 17 million letters each year on activity statement material.

Take up rates for Standard Business Reporting are also substantially below original targets and the Department of Immigration and Border Protection maintains a significant proportion of visa categories which are not electronic.

There is clearly scope for government to go further in terms of online provision of services compared to countries such as the United Kingdom and Denmark, which have made strong progress in moving service delivery online. In Denmark, the government has made it mandatory for citizens and businesses to receive correspondence electronically.

Three key factors have led to the relative success of Denmark and the United Kingdom with e-Government:

- they have a bold strategy and associated policies that are digital by default;
- there is senior ministerial ownership and a digital champion within Cabinet; and
- there is a strong central team to support the strategy.

The growing awareness and popularity of myGov offers the potential for significant change in Australia. However, these three factors must be addressed to drive cultural change across government.

An ambitious strategy is needed. The Commonwealth Government has made a commitment to ensure every government interaction that occurs more than 50,000 times per year can be undertaken online by 2017. It will also aim to make all government correspondence available digitally by 2017. The Commission considers government should do better than that.

The Government should adopt a transformative strategy to become digital by default for all transactions. The strategy should specify an explicit savings target to drive change. It should act decisively to remove legislative barriers to digital transactions.

It should set concrete milestones, including switching from an 'opt-in' arrangement for myGov to a default 'opt-out'.

The strategy should require agencies to make services available through mobile applications. It should have clear and ambitious timelines. It should aim to simplify departmental processes – there is limited value in collecting electronic information from citizens to feed into manual processes in departments.

The strategy should also strengthen the myGov online credential. This could be done through the addition of face-to-face verification or biometric information. It would result in a credential that could be used to prove identity in both the public and private sectors.

The strategy should cover citizens and business. For business, the Australian Business Number could become a standard online identifier – it is already being used extensively as an identifier with the AUSKey login by the Australian Taxation Office in the rollout of Standard Business Reporting.

While Standard Business Reporting offers significant potential to reduce the business costs of complying with the tax and superannuation systems, take-up rates to date are slow.

The digital strategy should require common reporting standards for business across government agencies. More should also be done to encourage business to adopt Standard Business Reporting. The Commission recognises businesses may incur costs in moving to make their own systems compatible with Standard Business Reporting standards, so commercial benefits need to be identified and communicated.

An ambitious digital strategy will only succeed if it is appropriately executed and implemented.

Australia's slow progress is partly attributable to the fragmented arrangements for e-Government across multiple agencies, including the Australian Government Information Management Office, other parts of the Department of Finance, the Attorney-General's Department and the Department of Communications.

The transition to e-Government would have far more traction if core expertise was consolidated in a single team led by a chief digital officer.

This would be a senior role filled by an accomplished private sector leader who has driven a major digital transition process. This person should report directly to the Minister for Communications. It may be appropriate for the chief digital officer to also lead the development of the new Government Payments System, reporting to the Minister for Human Services, as proposed in Section 10.4.

Ultimately, ministerial leadership will be required. The Commission encourages the Government to embrace a digital by default policy, led by a senior minister such as the Minister for Communications.

Recommendation 62: e-Government

e-Government services are often preferred by citizens, businesses and other government customers because they are more convenient and generally cheaper and more accurate. The Commission recommends that the Government accelerate the transition to online service delivery by:

- a. setting an ambitious digital strategy that:
 - i. makes myGov the default means of engaging with government, supported by 'opt-out' provisions;
 - ii. sets concrete savings targets;
 - iii. removes legislative barriers; and
 - iv. strengthens the myGov online credential;
- b. consolidating the e-Government effort through a single team under the leadership of a Chief Digital Officer; and
- c. appointing a senior minister to champion the digital by default agenda.

10.7 Cloud computing

The purchase, maintenance and upgrade of Information and Communication Technology (ICT) is expensive, particularly given the rapid pace of change. As a consequence, a global trend is developing for organisations to move away from owning and operating all ICT assets to more cost effective cloud computing models.

Cloud computing is a way of leasing computing services over a network. It allows costs to be shared across users, with rapid scalability on demand and fast access to new computing applications and systems as they become available.

Public cloud computing offers the greatest savings by amortising costs over millions of users globally. It can produce significant savings in the total cost of ownership, estimated at estimated 20 to 30 per cent of infrastructure costs. Private cloud facilities are more expensive but offer benefits such as increased security.

The emergence of cloud-based technology offers the potential for better efficiency and service standards across government. Savings are available across all three typical cloud service offerings: software, platform and infrastructure.

The Commonwealth Government has been slow to adopt cloud computing. A reliance on bespoke, legacy systems, concerns about the security and privacy of placing public data in the cloud, and general risk aversion all impede progress.

In accordance with the approach being adopted outside of government, for example in the banking sector, the Commission considers that a 'cloud first' policy, particularly for low risk, generic ICT services should be clearly articulated and enforced by the Government. Over three to five years, this could progressively reduce ICT costs as cloud computing becomes the default option.

In order to make it easier for departments to source cloud services with confidence, the Commission proposes the Department of Finance establish a whole of government cloud computing provider panel to confirm the viability, capability and costs of large-scale cloud computing providers. Agencies could then obtain quotes for such services as the need arises.

Competition should be maintained in the market for cloud providers by adding new vendors and services as they become viable. This would also allow government to establish standards for such services. The range of offerings in such a panel would allow agencies to procure public or private cloud computing services, with appropriate levels of security.

Recommendation 63: Cloud computing

Cloud computing is a way of leasing computing services over a network. It can reduce costs by sharing them across users. The Commission recommends that the Government increase its adoption of cloud computing by:

- a. introducing a mandatory 'cloud first' policy for all low risk, generic information and communication technology services; and
- b. establishing a whole-of-government cloud computing provider panel.

10.8 Corporate services and systems

All Commonwealth agencies perform common corporate functions, such as paying employees and preparing financial statements. Given these activities are common across government, there is scope for economies of scale to be achieved, both in the procurement of back-office technology and service delivery.

The Australian Public Service maintains a range of bespoke corporate ICT systems. Even where agencies have off the shelf systems, they often differ. For example, many agencies use the SAP enterprise resource planning software – there are more than 40 versions of the package currently in use.

The Commission considers the public service should aim to standardise corporate processes to improve purchasing power and to facilitate a move to shared services.

Shared services relates to the single provision of common functions to more than one organisation. They usually cover clearly specified elements of human resources, information management, communication, technology, procurement and financial management.

Shared services can avoid duplication of business functions, reduce costs and generate efficiencies.

Shared corporate services have been taken up to varying degrees by individual groupings of Commonwealth Government departments and agencies, but generally not at a whole of government level.

The approach to date has been relatively ad hoc and would benefit from better strategic planning. The Australian Public Service Commission's latest *State of the Service Report* noted agencies have been working together and coordinating the purchase of common goods and services, with two thirds reporting they had participated to some extent in a shared service arrangement.

The most common areas of shared services activities by agencies in 2012–13 are shown in Table 10.1 below.

Table 10.1: Shared services in the Australian Public Service

Type of service	per cent of agencies
Payroll	29
Security	27
Property	25
Finance	23
Human Resources	22
Parliamentary	16
Other	16
Communications	14
Employee assistance program	13
Administration	13
Legal	8

Source: Australian Public Service Commission 2012-13 State of the Service Report.

Any approach to shared services will need to be carefully researched and appropriately implemented.

A key lesson from other jurisdictions is standardising business processes is a necessary pre-condition to successful shared services projects and provides efficiencies just as significant as those gained from economies of scale.

In designing and implementing a shared service, departments and agencies should be clear in understanding:

- the scope, quality and costs of the existing services;
- services to be included in any arrangement and those that are out of scope;
- the clarity of benefits, including standardisation of processes, reduced duplication and decreased costs;
- the expected level of return on the investment over an agreed payback period;
- opportunities available to leverage technology advancements, such as cloud solutions;
- transitional arrangement requirements, such as moving to new shared service platforms as existing contracts expire; and
- whether private sector providers should be considered.

While whole-of-government shared services have the potential to deliver cost savings and efficiencies, the Commission suggests a staged approach to implementation is prudent.

The first step is to conduct a thorough audit of existing Commonwealth public sector corporate support services to understand costs, processes and models and the extent to which these can be standardised.

As part of this exercise, the Department of Finance should also publish a register of other business systems (for example stakeholder engagement software) to prevent agencies from building new software that already exists.

Agencies should also be grouped and corporate functions standardised within the groups. Grouping could be by: portfolios; 'like' agencies, such as economic or national security agencies; or according to the corporate systems currently in place, for example grouping all agencies currently using SAP accounting systems and moving to a common version, potentially in the cloud.

Moving to a clustering arrangement will make it easier and more practical to benchmark corporate services performance. As well as increasing the overall performance of public sector corporate services, this would deliver the information to standardise services and improve IT purchasing power prior to moving to shared services.

Recommendation 64: Corporate services and systems

All Commonwealth agencies perform common corporate functions, such as paying their employees and preparing financial statements. The Commission recommends the Government improve the efficiency of corporate services by:

- a. standardising corporate business processes;
- b. publishing a register of other business systems;
- c. improving procurement of corporate information and communication technology systems; and
- d. adopting a staged implementation of shared corporate services for Commonwealth Government departments and agencies.

11 – Reform and restructure of the Australian Public Service

Throughout its deliberations the Commission has been provided with a range of views on the structure, performance and effectiveness of the Australian Public Service.

A summary of the current structure of Commonwealth Government was outlined in Chapter Three and Chapter Nine contained the Commission's recommendations on the rationalisation of public sector bodies and agencies.

The Commission intends to examine in more detail issues associated with potential reform of the Australian Public Service in its Phase Two Report, scheduled for the end of March 2014.

Ahead of this, preliminary observations are outlined below.

At the whole of government level, the machinery of government changes that were implemented in September 2013 have significantly simplified and streamlined arrangements.

However, a more efficient and effective public sector also requires appropriate structures within portfolios and within individual organisations. The quality of leadership and management within the public service is likewise fundamental to improving operational performance.

11.1 The Public Service Act and the Public Service Commission

The Australian Public Service is the largest and most labour intensive employer in the country. Historically responsibility for recruitment, pay and conditions in the public service was centralised in the Public Service Board. However, over time, these functions were increasingly devolved to agency heads.

The *Public Service Act 1999* is the principal Act governing the establishment and operation of the Australian Public Service. Its main objectives are to:

- establish an apolitical public service that is efficient and effective in serving the government, the Parliament and the Australian public;
- provide the legal framework for the employment, management and leadership of Australian Public Service employees;

- define the powers, functions and responsibilities of agency heads (particularly with regards to accountabilities between agency heads and ministers), the Public Service Commissioner and the Merit Protection Commissioner; and
- establish the rights and obligations of Australian Public Service employees.

The Australian Public Service Commission has statutory responsibilities for leading and shaping the Australian Public Service. It falls within the Prime Minister and Cabinet Portfolio and receives funding of \$110 million and employs some 250 staff.

Unlike the former Public Service Board, the Australian Public Service Commission does not have a role to maintain centralised control over human resources, with agency heads receiving full managerial authority and responsibility under the Public Service Act.

There are different views on the appropriate role for the Australian Public Service Commission in a devolved public service. It has increasingly focussed on fee for service training delivery and the development of broad guidance for agencies on human resources matters.

The Commission of Audit will examine the ongoing role of the Australian Public Service Commission in greater detail as part of its considerations in its Phase Two Report.

11.2 Opportunities to improve public sector management

Deficiencies in the quality of public service leadership and management were raised in a number of the Commission's consultations.

A recent survey published by the Australian Institute of Management shows a higher level of disengagement among public sector managers when compared to the private sector and that public sector managers should be playing a stronger role in increasing organisational performance.

There is widespread recognition of the importance effective performance management and human resources systems can make to an organisation. One of the more pressing issues facing the public service today is how to develop a culture that is open to regular constructive feedback, mentoring, assessment and ongoing professional development.

The Commission is yet to determine whether there are legislative barriers that impede the effective management of individual performance or underperformance in the public sector. This will be a focus of its Phase Two work.

However, the Commission's preliminary consideration of the matter suggests attention needs to be given to improving management capabilities among senior public sector staff.

11.3 The Commission's intended approach

As outlined above and in accordance with its Terms of Reference, the Commission will examine in greater detail issues around public sector performance and accountability in its Phase Two work.

This work will build on aspects of the Commission's Phase One work as outlined in this report and identify further opportunities for reform including prospects for:

- clearer accountabilities and better alignment of roles and responsibilities;
- increased spans of control and reduced layers of management;
- improved performance measurement and better performance management; and
- greater efficiencies in corporate and support functions across government.

The Commission has been provided with preliminary information suggesting there is scope for substantial savings to government by pursuing reforms in these four areas.

The Commission will also report in its Phase Two work on the proposed accountability framework associated with the introduction of the *Public Governance, Performance and Accountability Act 2013* which is scheduled to take effect from 1 July 2014.

12 - Financial Implications

The Commission has made 64 Recommendations across a range of activities and programmes, consistent with the objective of achieving a surplus of 1 per cent of GDP by 2023-24.

Most of our suggested actions go to the structural design of the biggest and fastest growing programmes. A detailed portfolio-by-portfolio review should yield further significant additional savings but insufficient to fix the underlying fiscal problem.

The Commission has prepared estimates of indicative savings from its Recommendations. However, without decisions on detailed programme design and timing of implementation — which are matters for the Government — it is not possible to be definitive.

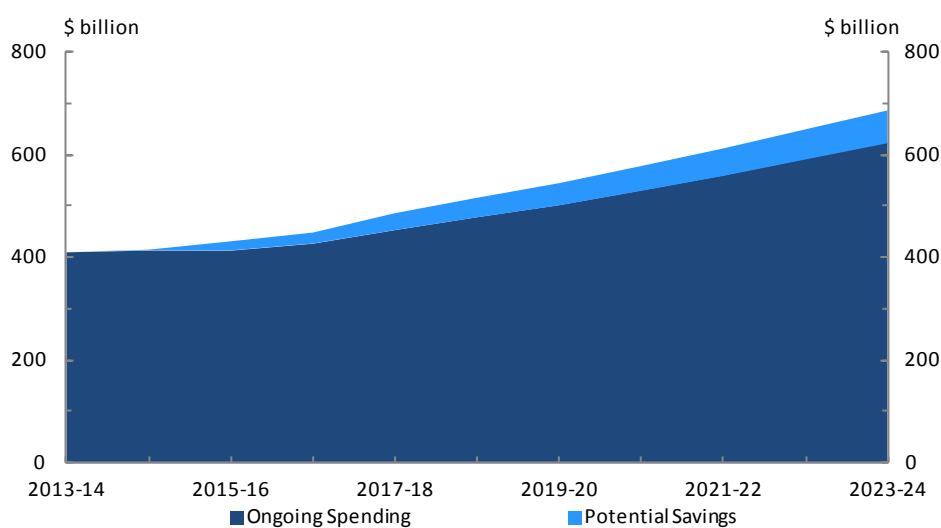
Detailed costings undertaken by Government as part of the Budget process would give greater clarity around the financial implications of the Recommendations.

The Commission expects that these more detailed costings would yield modest savings in the early years rising to some \$20 to \$30 billion per year by 2017-18. By 2023-24, the savings could grow to some \$60 to \$70 billion per year.

These estimated savings do not factor in the additional savings from lower public debt interest costs arising from lower levels of Commonwealth debt which could be in the order of \$15 to \$20 billion per annum by 2023-24.

Chart 12.1 illustrates the potential magnitude of the savings.

Chart 12.1: Potential savings from the Commission’s recommendations



Source: National Commission of Audit.

It should be noted that the Commission has not included in its projections the Government’s commitment to increase Defence expenditure to 2 per cent of GDP.

13 – Conclusion

The Commission supports the Government in its commitment to get the nation’s fiscal house in order.

This report has laid out a broad reform agenda that recognises the legitimate role of government and sets the Commonwealth budget on a more sustainable path.

We have to restrain spending, rebuild our financial capacity and restore the buffer needed to shock-proof the economy from a future crisis.

The Commission has made 64 recommendations across a range of activities and programmes. These savings, or other savings of a similar magnitude, are needed to deliver a surplus of 1 per cent of GDP by 2023-24.

The aspiration is for more responsible government – to spend taxpayers’ money wisely and focus more on what governments should do, rather than on those things that citizens can best do for themselves.

The Commission believes that ‘business as usual’ is not a viable option for Australia. Unless we take action now, there is a very real prospect of an unprecedented run of budget deficits and a build up in net debt. This would place a significant burden on future generations to bring the Budget back under control.

Achieving the target surplus will require a significant reduction in spending, while holding to a discipline that taxes rise no higher than 24 per cent of GDP. The Commission’s proposals can be implemented incrementally and in a way that does not harm the economy. In fact, taken together they should strengthen the economy.

Australia needs to embark on a path of reform and renewal. Restoring the nation’s finances can be achieved through a concerted effort to restrain spending assisted by fiscal rules that set some reasonable boundaries around government.

Good government breeds confidence.

Governments that successfully manage their own affairs set an example to the rest of society about their ability to cope with economic and social challenges.

We must face up to the task.

14 – Annexes

- A** **Terms of Reference**
- B** **Modelling assumptions**
- C** **Principal bodies for rationalisation**
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Annex A: Terms of Reference

Context

It is almost 20 years since there has been a thorough review of the scope, efficiency and functions of the Commonwealth government. During this time the size of the Commonwealth government has expanded significantly, as has the remit of some of its activities.

It is also essential that the Commonwealth government live within its means and begin to pay down debt.

It is therefore timely that there should be another full-scale review of the activities of the Commonwealth Government to:

- ensure taxpayers are receiving value-for-money from each dollar spent;
- eliminate wasteful spending;
- identify areas of unnecessary duplication between the activities of the Commonwealth and other levels of government;
- identify areas or programs where Commonwealth involvement is inappropriate, no longer needed, or blurs lines of accountability; and
- improve the overall efficiency and effectiveness with which government services and policy advice are delivered.

Accordingly, the Commission of Audit ('the Commission') has a broad remit to examine the scope for efficiency and productivity improvements across all areas of Commonwealth expenditure, and to make recommendations to achieve savings sufficient to deliver a surplus of 1 per cent of GDP prior to 2023-24.

In carrying out its work, the Commission may wish to invite submissions, consult key stakeholders and seek information from persons or bodies, where this will assist its deliberations.

The Commission should also be guided in its work by the principles that:

- government should have respect for taxpayers in the care with which it spends every dollar of revenue;
- government should do for people what they cannot do, or cannot do efficiently, for themselves, but no more; and
- government should live within its means.

Scope

Phase 1

Scope of government

The Commission is asked to assess the current split of roles and responsibilities between and within the Commonwealth government and State and Territory governments, including areas of duplication.

In relation to activities performed by the Commonwealth, the Commission is asked to identify:

- whether there remains a compelling case for the activity to continue to be undertaken; and
- if so, whether there is a strong case for continued direct involvement of government, or whether the activity could be undertaken more efficiently by the private sector, the not-for-profit sector, the States, or local government.

The Commission may consider and comment upon the current architecture of Commonwealth-State relations. The Commission's views on this issue will help to inform the Government's forthcoming White Paper on the Reform of the Federation.

Efficiency and effectiveness of government expenditure

The Commission is asked to report on efficiencies and savings to improve the effectiveness of, and value-for-money from, all Commonwealth expenditure across the forward estimates and in the medium term, including:

- options for greater efficiencies in the Australian Public Service, such as:
 - increasing contestability of services;
 - adoption of new technologies in service delivery and within government;
 - consolidation of agencies and boards;
 - rationalising the service delivery footprint to ensure better, more productive and efficient services for stakeholders;
 - flattening organisational structures and streamlining lines of responsibility and accountability;
 - consolidating government support functions into a single agency; and
 - privatisation of Commonwealth assets.

- potential improvements to productivity, service quality, and value for money across the public sector, including better delivery of services to the regions; and
- anything that is reasonably necessary or desirable to improve the efficiency and effectiveness of government generally.

The Commission is asked to review and report on:

- options to manage expenditure growth, including through reviewing existing policy settings, programs and discretionary spending (such as grants);
- savings and appropriate price signals — such as the use of co-payments, user-charging or incentive payments — where such signals will help to ensure optimal targeting of programs and expenditure (including to those most in need), while addressing the rising cost of social and other spending;
- mechanisms that allow for the periodic evaluation of the effectiveness of all areas of expenditure in meeting their announced objectives; and
- other savings or matters that the Commission considers should be brought to the Government’s attention.

State of the Commonwealth’s finances and medium-term risks to the integrity of the Budget position

The Commission is asked to assess the financial position of the Commonwealth, including the state of the balance sheet, including all assets and liabilities, and Commonwealth risk expenditures.

The Commission is asked to review and report on the long-term sustainability of the Budget position, identifying key policy areas where trends in expenses and revenue pose risks to the structural integrity of the Budget.

Where possible, the Commission should identify options to address any such budget risks in the medium to long-term, including by introducing appropriate incentives to encourage self-provision of services by individuals over time.

Adequacy of existing budget controls and disciplines

The Commission is asked to assess the adequacy of current budgetary practices and rules (including specified timeframes and targets) in promoting efficient and effective government, disciplined expenditure, long-term fiscal sustainability and budget transparency.

Phase 2

Commonwealth infrastructure

The Commission is asked to review and report on the extent, condition and adequacy of Commonwealth sector infrastructure and, if found to be deficient, factors that may have contributed to the current situation and possible remedies.

Public sector performance and accountability

The Commission is asked to:

- identify options for continuous assessment of programs, agencies and performance;
- identify options for strengthening Commonwealth budgeting arrangements by:
 - increasing independent and credible scrutiny;
 - examining the role of the Parliamentary Budget Office, the Australian National Audit Office and the Intergenerational Report; and
 - reviewing the way risk expenditures are accounted for.
- report on a methodology for developing and implementing financial performance targets for Commonwealth departments and agencies (having regard to international experience and Australian best-practice, including by government business enterprises);
- review and report on the effectiveness of existing performance metrics and options for greater transparency and accountability through improved public reporting;
- identify options for a clearer delineation of responsibilities for policy and service delivery; and
- identify other savings or matters that the Commission considers should be brought to the Government's attention.

Reporting

The Commission will report to the Prime Minister, Treasurer and Minister for Finance with:

- the first phase due by the end of January 2014; and
- the second phase due by no later than the end of March 2014.

Annex B: Modelling assumptions

The Commission has produced projections of budget aggregates (underlying cash balance, net debt, total receipts and total payments) and some of the large and strong growing programmes. These projections are largely based on material contained in the 2013-14 Mid-Year Economic and Fiscal Outlook.

Methodology of budget aggregate projections

The Budget aggregate projections are based on projections from the 2013-14 MYEFO. Where the Commission has made its own assumptions (for instance about future tax revenue), these are noted in the report.

The Commission has used Treasury's fiscal aggregate projection model (FAPmod) to produce the aggregate projections.

FAPmod combines projections of receipts, payments and balance sheet components to produce an internally consistent cash and accrual framework, with interconnected operating and cash flow statements and balance sheet.

This differs to the approach used for budget aggregates across the forward estimates period, where estimates are based on detailed programme level information.

Further information about Treasury's FAPmod can be found in *Australian Government 2009*.

Receipt projections

Medium-term tax receipts are projected by head of revenue using parameters for wages, profits and consumption linked to nominal GDP growth - similar to the revenue projections for the last two years of the forward estimates period.

Consistent with current presentation in the Budget papers, the underlying cash balance does not include earnings from the Future Fund. For simplicity and consistency the charts displaying projections of total receipts do not include Future Fund earnings.

Payment projections

Payments are projected using a suite of models, including models that project spending on health, income support payments, education and training, aged care, major superannuation defined benefit schemes and defence. Whilst the details of the various spending models differ, they are mainly driven by expected changes in demand (in most cases driven by demographic change) and prices.

A number of programme estimates are included in the aggregate projections where programmes are expected to have a substantial financial impact beyond the forward estimates period, for example the National Disability Insurance Scheme.

The underlying cash balance does not include operating costs of the Future Fund. For simplicity and consistency the charts displaying projections of total payments do not include the operating expenses of the Future Fund.

Economic and demographic projections

The fiscal aggregate and programme projections are based on economic and demographic parameters.

These parameters are based on medium-term assumptions of growth consistent with historical experience adjusted, where appropriate, for long-term factors such as demographic change.

Further detail on the significant parameters is below.

Real Gross Domestic Product

Real GDP is assumed to grow by 2½ per cent in 2013-14 and 2014-15, and 3 per cent per year in 2015-16 and 2016-17.

Beyond the forward estimates, real GDP is assumed to grow at its trend rate of around 3 per cent per year. Trend growth in real GDP is projected to slow early next decade as the participation rate declines with Australia's ageing population.

Inflation

Consumer Price Inflation is projected to be around 2½ per cent per year from 2015-16 consistent with the Reserve Bank's medium-term target band.

Nominal Gross Domestic Product

Nominal GDP is assumed to grow at 3½ per cent per year in 2013-14 and 2014-15, increasing to 4¼ per cent per year in 2015-16 and 2016-17.

Nominal GDP growth is determined by the combination of real GDP growth and economy wide prices and is around 5½ per cent per year beyond the forward estimates period.

Unemployment rate

An unemployment rate of 6 per cent in 2013-14 and 6¼ per cent in 2014-15 has been assumed. The unemployment rate is projected to remain around 6 per cent beyond 2014-15.

Participation

A participation rate of around 65 per cent in 2013-14 is projected. This rate falls over time, primarily due to the impact of the ageing of the population.

Productivity

Labour productivity is assumed to grow at a rate of 1.6 per cent per year, reflecting historical annual rates.

Wages growth

Growth in wages is assumed to be around 2.75 per cent per year in 2013-14 and 2014-15. From 2015-16 growth in wages is projected to be 4 per cent per year. This reflects growth in the CPI and labour productivity.

Terms of trade

It has been assumed that the terms of trade decline until 2019-20, when they reach a long-run level similar to the level in 2006-07. They then remain at this level.

'Business as Usual' scenario

In the 'Business as Usual' scenario, estimates and projections of payments and receipts draw on material presented in the 2013-14 MYEFO.

However, tax collections are limited to 24 per cent of GDP.

Payments increase in line with published 2013-14 MYEFO numbers, with some differences occurring through higher public debt interest payments, due to weaker budget projections than at the 2013-14 MYEFO.

'Reform' scenario

The 'Reform' scenario makes the assumption that tax receipts do not exceed 24 per cent of GDP, (the same assumption as the 'Business as Usual' scenario) and that growth in payments is constrained such that the Budget improves to a 1 per cent of GDP surplus in 2023-24.

The constraint on payments begins in 2014-15 and continues until 2023-24.

Methodology of programme projections

The Commission has published projections of expenditure for the large and fast growing programmes.

These projections are based on an accrual framework.

The programme projections are based on the 2013-14 MYEFO. This does not include the commitment to increase Defence expenditure to 2 per cent of GDP within a decade.

Beyond 2016-17, programme-specific models have been used to project expenditure. These models are based on those used for the forward estimates, with modifications to incorporate drivers of programme growth over the longer term. Whilst the projections make

use of the most appropriate assumptions, a high level of uncertainty is inherent in this form of modelling.

Hospitals

Hospital expense projections reflect the Commonwealth contribution to public hospital funding under the Commonwealth/State National Health Reform Agreement. Projections exclude public hospital spending on veterans.

Pharmaceutical Benefits Scheme

Pharmaceutical Benefits Scheme (PBS) projections reflect PBS expenditure under the *National Health Act 1953*. The Repatriation Pharmaceutical Benefits Scheme, which is a separate scheme funded through the Department of Veterans' Affairs, has not been included.

Medicare Benefits Schedule

Medicare Benefits Schedule projections reflect Medicare Benefits Schedule expenditure under the *Health Insurance Act 1973*.

National Disability Insurance Scheme

National Disability Insurance Scheme projections reflect the Commonwealth's contribution to the scheme, net of National Disability Specific Purpose Payment and existing Commonwealth programs that provide disability care and support services.

Income support for carers

Income support for carers projections reflect the five major areas of support: Carer Payment (the main income support payment); Carer Allowance (Adult); Carer Allowance (Child); Carer Supplement; and Child Disability Assistance. Only the special appropriations have been modelled.

Child care fee assistance

Child Care Fee Assistance projections reflect the Child Care Benefit and the Child Care Rebate.

Paid Parental Leave

Expenditure in 2013-14 and 2014-15 relates to the scheme as at the 2013-14 MYEFO. The remaining years relate to the Government's proposed new scheme.

Disability Support Pension

Disability Support Pension (DSP) projections reflect the special appropriations for DSP.

Age Pension

Age pension projections reflect the special appropriations for Age Pension (including the pension supplement). The Wife Pension and Widow B Pension have not been included.

Aged care and population ageing

Aged care and population ageing projections reflect special appropriations for the Home Support, Home Care, Residential and Flexible Care programs. The Department of Veterans' Affairs component of the Residential Care programme is also included.

Family Tax Benefit

Family Tax Benefit projections reflect the special appropriations for Family Tax Benefit Part A and Part B.

Schools funding

Schools funding projections reflect funding for both non-government and government schools and include funding the *Students First - a fairer funding agreement for schools* package. For the purpose of producing these projections it has been assumed that the former Government's Better Schools Plan is implemented in full and funding provided to non-participant States and Territories continues beyond 2017.

Higher education

Higher education projections reflect expenditure projections for the Higher Education Support programme. The main element of this programme is the Commonwealth Grant Scheme. Other elements include supplementation for unfunded superannuation liabilities payments, support for students with a disability and funding to universities with students from low socio-economic status backgrounds.

Official Development Assistance

Official Development Assistance projections reflect all Official Development Assistance-eligible expenditure and include both global (multilateral) and country (bilateral) programs and some departmental funding.

Defence

Defence projections are on the basis of expense estimates for the Defence function (including the Department of Defence, Defence Materiel Organisation and other smaller agencies in the function). Superannuation costs and expenses related to the Department of Veterans' Affairs and Defence Housing Australia are not included. The projections also include Defence function net capital investment and as such the Defence projections are not pure expense numbers.

The defence projections differ slightly from the other expense projections, as they reflect the function and not the programme.

Job Seeker Income Support

Job Seeker Income Support projections include projections for Newstart Allowance and Youth Allowance (other). This projection is heavily dependent upon the assumed unemployment rate of around 6 per cent.

References

Australian Government 2009, *Economic Roundup issue 3*, Australian Government, Canberra

Annex C: Principal bodies for rationalisation

Table C.1: Principal bodies for rationalisation

Bodies	Bodies
<p>Abolishing</p> <p>Australian Inst. for Teaching & School Leadership Ltd Australian Reinsurance Pool Corporation Clean Energy Finance Corporation Climate Change Authority Export Finance and Insurance Corporation IIF Investments Pty Ltd Low Carbon Australia Limited</p> <p>Merging with other bodies</p> <p>Administrative Appeals Tribunal Australia Council Australian Business Arts Foundation Ltd. Australian Comm. on Safety & Quality in Health Care Australian Crime Commission Australian Institute of Health and Welfare Australian National Preventive Health Agency Australian Pesticides and Veterinary Medicines Auth. Australian Skills Quality Authority Bundanon Trust Cancer Australia ComSuper CrimTrac Agency Family Court and Federal Circuit Court of Australia Federal Court of Australia Grape and Wine Research and Development Corp. Independent Hospital Pricing Authority Indigenous Business Australia Indigenous Land Corporation Inspector-General of Taxation Migration Review Tribunal and Refugee Review Tribunal National Competition Council National Health and Medical Research Council National Health Funding Body National Health Performance Authority National Mental Health Commission Office of the Auditing and Assurance Standards Board Office of the Australian Accounting Standards Board Office of the Commonwealth Ombudsman Office of the Fair Work Ombudsman Private Health Insurance Administration Council Private Health Insurance Ombudsman Screen Australia Tertiary Education Quality Standards Agency Wine Australia Corporation</p> <p>Consolidating into departments</p> <p>Albury-Wodonga Development Corporation Asbestos Safety and Eradication Agency Australian Curriculum, Assessment & Reporting Auth. Australian Law Reform Commission Australian Renewable Energy Agency Australian Trade Commission Comcare Corporations and Market Advisory Committee</p>	<p>Consolidating into departments (continued)</p> <p>Defence Materiel Organisation Director of National Parks General Practice Education and Training Ltd Health Workforce Australia Murray-Darling Basin Authority National Blood Authority National Water Commission Organ and Tissue Authority Professional Services Review Scheme Safe Work Australia Seafarers' Safety, Rehabilitation & Compensation Auth. Telecomm. Universal Services Management Agency Tourism Australia Workplace Gender Equality Agency</p> <p>To be considered for privatisation</p> <p>ASC Pty Ltd Australian Hearing Services Australian Postal Corporation Australian Rail Track Corporation Defence Housing Australia Medibank Private Ltd Moorebank Intermodal Company Limited NBN Co Limited Royal Australian Mint</p> <p>Review, with a view to merging, abolishing or transferring</p> <p>AAF Company Aboriginal Hostels Limited Anindilyakwa Land Council Army & Air Force Canteen Service Australian Customs and Border Protection Service Australian Film, Television and Radio School Australian Inst. of Aboriginal & Torres Strait Islander Studies Australian Institute of Criminology (AIC) Australian Military Forces Relief Trust Fund Australian Securities and Investments Commission Australian Transaction Reports and Analysis Centre Central Land Council Department of Immigration and Border Protection National Capital Authority National Transport Commission Northern Land Council Outback Stores Pty Ltd RAAF Veterans' Residences Trust Fund RAAF Welfare Recreational Company Royal Australian Air Force Welfare Trust Fund Royal Australian Navy Relief Trust Fund Royal Australian Navy Central Canteens Fund Sydney Harbour Federation Trust Tiwi Land Council Torres Strait Regional Authority Wreck Bay Aboriginal Community Council</p>

Source: National Commission of Audit.

Annex D: Grant programmes

Table D.1: Grant programmes for abolishing or merging

Grants

Abolishing

Asian Century Business Engagement Plan Grants
Collaborative Research Networks
Commercialisation Australia
Community Broadcasting Programme
Creative Young Stars Programme
Enterprise Connect Innovation Centres
Enterprise Solutions Programme – Establishment
Export Market Development Grants
Industry Collaboration Fund
Industry Innovation Precincts
Innovation Investment Fund
National School Chaplaincy and Student Welfare Programme
Parliament and Civics Education Rebate
Rural Financial Counselling Service
Small Business Advisory Services Programme
Suburban Jobs Programme
Tourism Quality Grants
Voluntary Environment, Sustainability and Heritage Organisations

Merging

National Environmental Research Programme
Australian Biological Resources Study National Taxonomy Research Grant

Source: National Commission of Audit.

ABBREVIATIONS

ABC	Australian Broadcasting Corporation
CPI	Consumer Price Index
CSIRO	Commonwealth Scientific and Industrial Research Organisation
EFIC	Export Finance and Insurance Corporation
FTB-A	Family Tax Benefit Part A
FTB-B	Family Tax Benefit Part B
GDP	Gross Domestic Product
GST	Goods and Services Tax
HELP	Higher Education Loan Programme
NDIS	National Disability Insurance Scheme
PBS	Pharmaceutical Benefits Scheme
SBS	Special Broadcasting Service Corporation

Annex F: List of public submissions

The Commission called for public submissions in the week of 4 November 2013 via advertisements in national, metropolitan and regional newspapers and the Commission's web site. Submissions were received from 288 individuals, organisations and businesses as part of this process.

A small number of those making submissions chose to make follow up submissions. These are counted in the total.

The Commission also received submissions from the governments of each State and Territory and from a number of Australian Public Service departments and other entities.

A list of public submissions follows.

Individuals

Glenn Appleyard	Leon Francis	Dean McCrae
Chris Baulman	Brijesh Ghodasara	James McGrory
Bob Beadman	Rona Goold	Bernie McKay
William Boyd	Martin Gordon	David Norman
Neil Brown QC	Graham Gourlay	Frank Ondrus
Valmai Burnett	Eric Gribble	Grace Oryem
Jane Carrigan	Loris Hemlof	Ben Pook
Barry Catchlove	Geoff Henkel	Julian Rait
Richard Court AC	Neil Hermes	Leonie Ramsay
Paddy Dewan	Tim Holland	Gavin Scrimgeour
Paul Dibb	Roger Jennings	Rose Spear
Bob Dollery	Eva Johansson	Wilson Tuckey
James Eagles	Peter Katsambanis MLC	John Wayland
Glen Eaves	Stuart Kelly	Garry White
David Eccles	Robert Ludlow	Mark White
Christina Faulk	John McAuley	

Organisations and business

Abbott Australasia
Accenture Australia
Accord Australasia
ADJ Consultancy Services
Aged and Community Services Australia
AgriFood Skills Australia
Allygroup
Alzheimer's Australia
AMES
Anglicare Australia
Argos Consulting
Asciano, Aurizon, Australian Rail Track Corporation, Australasian Railway Association (joint submission)
Association of Australian Medical Research Institutes
Association of Independent Retirees
Australian Academy of Science
Australian Business Roundtable for Disaster Resilience and Safer Communities
Australian Chamber of Commerce and Industry
Australian Conservation foundation
Australian Council for International Development
Australian Council for Private Education and Training
Australian Council of Social Service
Australian Council of Trade Unions
Australian Diagnostic Imaging Association
Australian Food and Grocery Council
Australian Healthcare and Hospitals Association
Australian Hearing
Australian Hotels Association
Australian Industry Group
Australian Industry Group Defence Council
Australian Information Industry Association
Australian Local Government Association
Australian Logistics Council
Australian Major Performing Arts Group
Australian Medical Association
Australian Medicare Local Alliance
Australian Osteopathic Association
Australian Parents Council
Australian Petroleum Production and Exploration Association
Australian Private Equity and Venture Capital Association
Australian Private Hospitals Association
Australian Psychological Society
Australian Renewable Fuels
Australian Self-Medication Industry
Australian Services Union
Australian Strategic Policy Institute
Australian Subscription Television and Radio Association
Australian Technology Network of Universities
Banyer and Associates
Benetas
Bond University
Brewers Association
Bupa Australia
Business Council of Australia
Business Council of Co-operatives and Mutuals
BusinessSA
Butterfly Foundation

CA Technologies	Dietitians Association of Australia
Canberra Airport	Distilled Spirits Industry Council of Australia
Capital Markets and Cooperative Research Centre	Early Childhood Australia
Carers Australia	EARtrak
Carlton and United Breweries	Electrical Trades Union of Australia
Catholic Health Australia	Emantra
Catholic Social Services Australia	Energy Australia
Central Australian Aboriginal Legal Aid Service	Engineers Australia
Centre for Independent Studies	Exercise and Sports Science Australia
Certain Planning	Families Australia
CGI Australia	Family and Relationship Services Australia
Challenger Limited	Financial Counsellors' Association of Queensland
Christian Education Ministries	Financial Services Council
Citizens Against Fluoridation	First Peoples Disability Network
City of Sydney	ForestWorks Industry Skills Council
Civil Contractors Federation	Free TV Australia
Clarius Group	Friendly Societies of Australia
CollabIT ACT	Future Asset Services
Commonwealth and Public Sector Union	Generic Medicines Industry Association
Communication Workers Union	Good Technology
Community Broadcasting Association of Australia	Google Australia, PwC and Cisco Australia (joint submission)
Community Council for Australia	Governance Institute of Australia
Community Employers WA	Grattan Institute
Community Services and Health Industry Skills Council	Grattan Institute Health Program
Concerned Citizens of Geelong Society	Grattan Institute Higher Education Program
Consult Australia	Griffith University
Consumers Health Forum of Australia	Harness Racing Australia
COTA Australia	hirmaa
Council of Capital City Lord Mayors	Homelessness Australia
Council of Small Business Australia	Housing Industry Association
CPA Australia	IBM Australia and New Zealand
CropLife Australia	Imperial Tobacco Australia
DataFlex	

Independent Schools Council of Australia
 Indue Limited
 Industry Skills Councils
 Industry Super Australia
 Innovative Research Universities
 Inspire Foundation / ReachOut.com
 Institute of Chartered Accountants Australia
 Institute of Internal Auditors - Australia
 Insurance Australia Group
 International Education Peak Bodies
 iWebGate technology
 Jobs Australia
 Kidney Health Australia
 La Trobe University
 Large Law Firm Group
 Leading Age Services Australia
 Leukaemia Foundation of Australia
 Lion Pty Ltd
 Logan: City of Choice Leadership Team
 Macular Disease Foundation Australia
 Master Builders Australia
 McMillan Shakespeare
 Medibank
 Medicines Australia
 Mental Health Council of Australia
 Merck Sharp and Dohme
 MIG Group
 Migration Council
 Minerals Council of Australia
 Mission Australia
 Moorebank Intermodal Company
 Murdoch University
 National Alcohol Beverage Industries Council
 National Catholic Education Commission
 National Congress of Australia's First Peoples
 National Council of Single Mothers and Their Children
 National Employment Services Association
 National English Language Training Accreditation Scheme
 National Famers' Federation
 National Heart Foundation
 National Industry Skills Council
 National Retail Association
 National Rural Health Alliance
 National Tertiary Education Union
 National Tourism Alliance
 National Welfare Rights Network
 Navitas
 NEXA
 nib Health Funds
 NPS MedicineWise
 NRAS Providers
 NRMA Insurance Group
 NSW Secondary Principals' Council
 Oakton Services
 Organic Waste Management
 Our HR Company
 Palliative Care Australia
 PC JAK Consulting
 Pernod Ricard Winemakers
 Pharmaceutical Society of Australia
 Pharmacy Guild of Australia
 Plastics and Chemicals Industries Association
 Post Office Agents Association
 Private Healthcare Australia
 Productivity Now

Professionals Australia
 Property Council of Australia
 PSInnovation
 Public Health Association of Australia
 Qube Holdings
 Queensland Youth Housing Coalition
 Random Computing Services
 Real Estate Institute of Australia
 Real Health Care Reform
 Recoveries Corporation Group
 Regional Australia Institute
 Regional Development Australia Hunter
 Regional Universities Network
 Research Australia
 Richmond Fellowship of Western Australia
 Royal Society for the Blind
 Rural Health Workforce Australia
 Salini Australia
 SAP Australia
 Service Skills Australia
 Service to Youth Council Inc.
 Services for Australian Rural and Remote Allied Health
 SmarterKnowledge
 Society of Hospital Pharmacists of Australia
 St Vincent de Paul Society
 Standards Australia
 Suicide Prevention Australia
 Suncorp
 Sydney Airport Corporation
 TAFE Directors Australia
 Telstra
 Tenants' Union of Queensland
 The Services Union
 The Smith Family
 Toll Group
 Tomorrow's Agenda Research Institute
 Tourism Shopping Reform Group
 Transport and Logistics Industry Skills Council
 United Voice
 UnitingCare Australia
 Universities Australia
 Universities Australia - Health Professions Education Standing Group
 University of Adelaide
 University of Melbourne
 University of New South Wales
 University of Sydney
 Urban Development Institute of Australia
 Urbis
 Veda
 Vedelem
 Victorian Healthcare Association
 Vision Australia
 Volunteering Australia
 Yarris

